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BusinessWeek

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40 Million
Credit Card Numbers Stolen from TJX
98,930 Affected In Forever 21 Data Breach
Trojan horse captures data on 2,300 Oregon taxpayers 5C
Hotel Chain Falls Victim to 14,000 Data-Stealing Malware incidents
University of Indianapolis Hacked: 11K Student, Faculty, Staff Records Stolen
4C
6,700 Data-Stealing Malware Infections Plague US Healthcare Company


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Majid Al-Ghaslan's university in Saudi Arabia is collaborating with IBM on research

(COVER) ILLUSTRATION BY GARY NEILL; (ABOVE) BEN BAKER/REDUX PICTURES

IN DEPTH

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Lewis Kaden, a top adviser to Vikram Pandit, may be the most influential banker you've never heard of



BARRY DILLER'S BRASH NEW STRATEGY

He's been a TV executive, home shopping baron, and e-commerce impresario. Now, with a plan to make companies pay for online content, the media mogul is out to change the economic model for making money on the Web. | BW | PAGE 53



Joy Mosley's company saw its premiums jump 72% when one employee got sick

A SMALL-BIZ HEALTH TRAP

It's a scenario playing out at many small companies: Just one employee develops a serious illness, and premiums rise so high that insurance becomes prohibitive. | BW | PAGE 60

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Jack and Suzy Welch are off this week

(L TO R) ILLUSTRATION BY ANDRÉ CARRILHO; THOMAS STRAND



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THE BUSINESS WEEK

EDITED BY HARRY MAURER & CRISTINA LINDBLAD

ECONOMICS & POLICY



Snapped up in Oregon: New-home sales jumped 9.6% in July over June

BERNANKE GETS THE NOD

Four more years! On Aug. 25, **Fed Chairman Ben Bernanke** won a thumbs-up from **President Barack Obama** for another four-year term in one of Washington's toughest jobs, starting in February. Obama credited the central banker with "calm and wisdom" as well as "bold action and out-of-the-box thinking." Bernanke's reputation is climbing with every bit of evidence that the economy is ready to leave the intensive-care unit. Home sales in July jumped 9.6% for newly built single-family homes and 7.2% for existing homes. The **Standard & Poor's/Case-Shiller U.S. National Home Price Index** rose in the second quarter from the first—such a gain hadn't occurred in three years. Durable goods orders grew 4.9% in July, thanks to big gains in aircraft orders. On the other hand, even the Administration concedes unemployment will run close to 10% through next year, and on Aug. 25 the White House said it expects federal budget deficits over the next decade to total $9 trillion.

| BW | PAGE 028 "Low Rates As Far As Bernanke Can See"

FINANCE

BANKS FALLING FAST

Take enough money to your local branch these days, and you might get more than a toaster—you might get the bank itself. The Aug. 21 seizure of **Guaranty Bank** in Texas boosted the number of bank failures to 81 this year—after just 25 last year—and Rochdale Securities analyst Richard Bove estimates that up to 200 more U.S. banks could collapse in the downturn. Any pickup in the pace would put more pressure on federal regulators to loosen the terms they proposed earlier this summer for buyers of failed banks—a move that could bring in more bids from private equity firms, which balked at the stiff capital and cross-ownership standards.

| BW | PAGE 026 "Are Banks Playing It Too Safe?"

GOLDMAN'S 'HUDDLES'

Goldman Sachs tends to make very big bucks, but recently some of its methods have been called into question. The latest critique came on Aug. 24, when *The Wall Street Journal* reported that Goldman holds weekly "trading huddles" during which analysts give out stock tips for dozens of favored clients—tips that sometimes differ from research reports that go to its thousands of not-so-privileged investors. Goldman's comment: The information is just short-term "market color" for clients who want to trade a lot, and it is "always consistent with the fundamental analysis" in published research. On Aug. 25, Massachusetts' chief financial regulator subpoenaed the firm, asking for information on the huddles.

Goldman's Lloyd Blankfein: Does the firm favor some clients?



(TOP TO BOTTOM) DON RYAN/AP PHOTO; JOSHUA ROBERTS/BLOOMBERG NEWS

STRATEGY

P&G UNLOADS DRUGS

After two decades in the prescription-drug business, **Procter & Gamble** decided to pull the plug, selling the unit on Aug. 24 for $3.1 billion to Ireland-based specialty drugmaker **Warner Chilcott.** The deal al-

lows P&G to concentrate on its more lucrative over-the-counter business, with such brands as **Vicks** and heartburn treatment **Prilosec.** As for Warner Chilcott, which set up in Ireland for tax purposes on Aug. 21, the 100% debt-financed purchase will triple revenues and expand its arsenal to include such medicines as osteoporosis fighter **Actonel.**

WHO'LL DRIVE OPEL?

General Motors' new board seems ready to take on the world—or at least the German government. The carmaker looked near a deal to sell a controlling stake in its European Opel unit to Canadian parts maker **Magna International** and its Russian partner, **OAO Sberbank,** with $6.5 billion in financing from Berlin. But GM's board declined to decide on Aug. 21, and the company has since asked Germany to finance instead a deal with Belgian investment firm **RHJ International.** The board also wants to ponder keeping Opel in GM's hands with financing from another source—or letting it go into liquidation. **German Chancellor Angela Merkel** is desperate to land an Opel deal to preserve 15,000 of the company's 25,000 jobs before a Sept. 27 national election. Someone will have to blink first.

LEADERSHIP

ARNOLD'S AUCTION

With his state's finances in the dumps, **Governor Arnold Schwarzenegger** is making like any other struggling family man—he's selling off miscellaneous stuff. Some of the items in what's being called the **Great California Garage Sale** are listed on **eBay** and **Craigslist.** The rest will be sold at a warehouse in Sacramento on Aug. 28 and 29. The inventory includes surplus computers, office equipment, and electronics. Some of the merchandise—jewelry, an antique piano, **Sacramento Kings** memorabilia—is property confiscated by the state **Highway Patrol.** The Governator personally signed the visors of 15 automobiles being auctioned off. At press time the high-



Making Opels in Germany: GM's board wants to rethink a deal to sell the unit

VOLKER HARTMANN/AFP/GETTY IMAGES

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Coverage not available everywhere. Data plan required. Connectivity dependent upon capability. The 3G Sprint Mobile Broadband Network reaches over 253 million people. Offer not available in all markets/retail locations or for all devices/networks. Other restrictions apply. See store or sprint.com for details. *PC World's* tests included 13 major cities with more than 20 tests per city from all regions of the country for each provider's 3G service. Testing was one minute in duration, and network performance can be highly variable from neighborhood to neighborhood. ©2009 Sprint. Sprint and the logo are trademarks of Sprint. Other marks are the property of their respective owners.

est bid ($7,500) belonged to a 2003 **Honda Civic Hybrid** with 98,000 miles on it.

TED KENNEDY'S LEGACY

After a struggle with brain cancer, **Senator Edward Kennedy** (D-Mass.) died on Aug. 25 at 77. Even colleagues who disagreed with his liberal politics lauded Kennedy for his legislative savvy and the connections he built across party lines over a 46-year career. Given his longtime leading role in the push for health-care reform, his absence from Senate negotiations in recent months has made it tougher to find bipartisan compromise; now his vacant seat leaves the Democrats one vote short of the 60 needed to head off a filibuster. Moreover, if **Senator Chris Dodd** (D-Conn.) opts to give up the chairmanship of the **Senate Banking Committee** to take



Kennedy: His death may affect the prospects for a health-care reform package

MIKE LYNAUGH/RETNA

over the **Health, Education, Labor & Pensions Committee,** Kennedy's passing could have big implications for financial services reform as well.

▸ "Kennedy: Health Care Loses a Champion"
businessweek.com/magazine

TECHNOLOGY

READ THIS, KINDLE

Amazon's e-reader will have a big-name rival this Christmas. On Aug. 25, **Sony** showed off a touchscreen e-book reader that will go page to page with Amazon's popular Kindle devices when it ships this December. The $399 **Sony Reader Daily Edition**—$100 more than the cheapest Kindle—connects to a wireless bookstore via **AT&T's** 3G network and lets readers tap the 7-inch screen with a stylus or their finger to turn pages and take notes. The gizmo will join Sony's lineup of two less expensive e-readers, making for a trio that the company figures will expand the market beyond travelers and avid readers.

▸ "Sony's Family of E-Readers Grows"
businessweek.com/magazine

$9 trillion

Projected federal budget deficit over the next 10 years, $2 trillion more than forecast in February

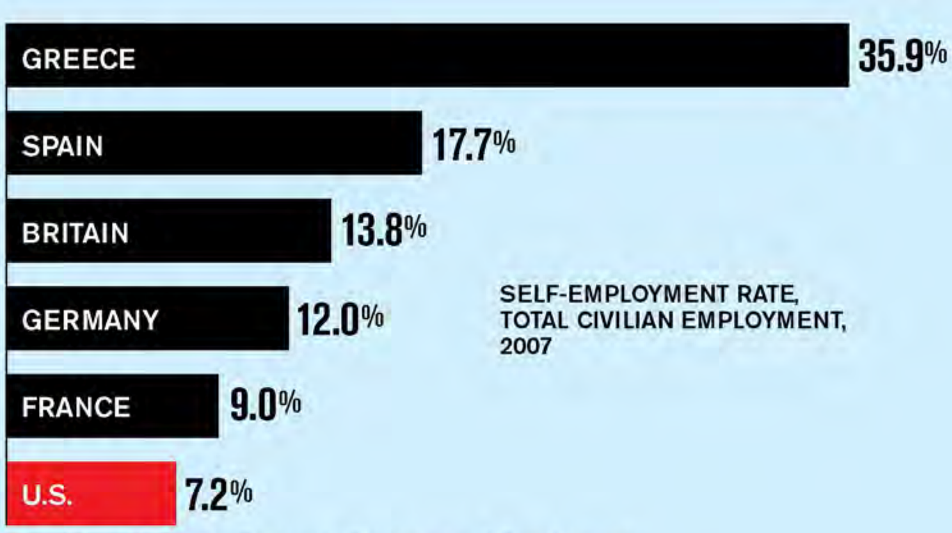
Data: Office of Management & Budget

IDEAS IS THE U.S. REALLY A HOTBED OF SMALL BUSINESS?

Those who favor the American brand of laissez-faire capitalism over the European version like to point to the dynamism of the U.S. small-business sector. Americans are endowed with the spirit of entrepreneurship, these folks say. And a combination of low taxes, limited regulation, and unfettered labor markets allows them to give that spirit free rein.

But is that argument backed up by the numbers? **John Schmitt** and **Nathan Lane** of the **Center for Economic & Policy Research** published a paper in August asserting that the U.S. lags most European economies—and a few Asian ones—in small-business employment. Using data from the **Organization for Economic Cooperation & Development,** the pair found that the U.S. ranked second to last out of 22 countries in the proportion of the total workforce that's self-employed, with 7.2%. The U.S. also ranks close to the bottom when it comes to workers employed in small manufacturing outfits—and surprisingly, in computer-related services.

Schmitt and Lane's study, however, has already come in for its share of opprobrium. One critic, writing on the **Small Business Labs** Web site, points out that the OECD numbers only include the unincorporated self-employed. When other measures are used, the U.S. moves much closer to the overall European rate.



Data: Organization for Economic Cooperation & Development

▸ Center for Economic & Policy Research



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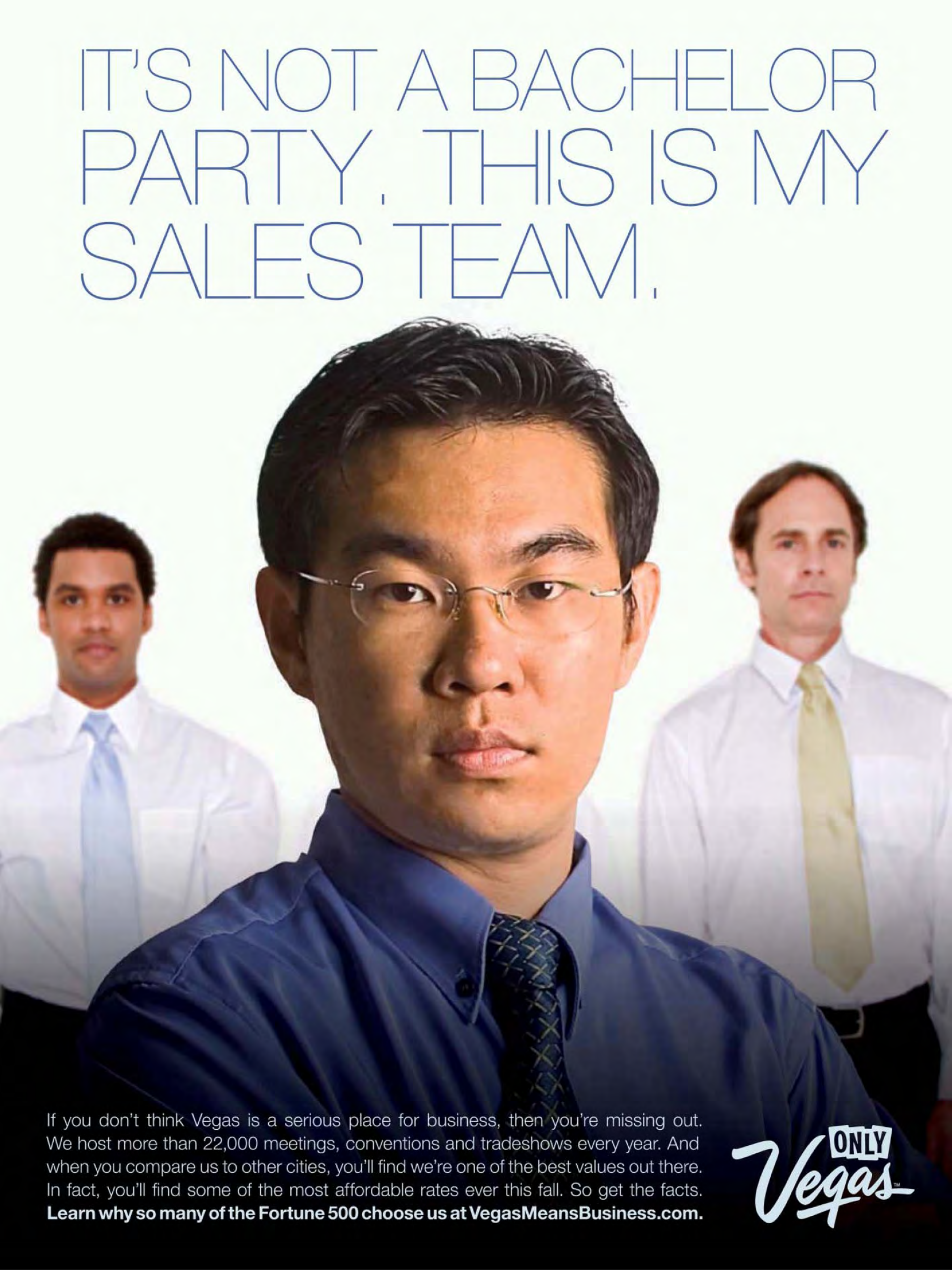
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(TOP TO BOTTOM) BRAD TRENT; JENNIFER S. ALTMAN

JOHN GUTFREUND'S GUT FEELING

As *BusinessWeek* went to press on Aug. 26, the Dow had been gaining for six consecutive sessions, President Obama had nominated Ben Bernanke to a second term as Federal Reserve chairman, and there were modest signs of life in housing. But not everyone is sanguine about the road ahead. To get some perspective, I talked with one of Wall Street's elder statesmen, John Gutfreund, onetime CEO of Salomon Brothers and current president of the financial consultancy Gutfreund & Co.

MARIA BARTIROMO
New York University economist Nouriel Roubini wrote an op-ed on Aug. 23 saying he's worried about a double-dip recession. Are you?

JOHN H. GUTFREUND
Roubini is being intelligent and cautious. I think the market is unduly exuberant, and there are a number of problems that will begin to loom heavier.

Like what?
Like unemployment heading for 10%. The U.S. has had some successes, but fundamentally it's been successful in bailing out the big banks. It hasn't been lending to the public. The biggest loan to the public is the car deal, which is ending.

Wasn't that a small program in the big scheme of things?
Psychologically, it was important.

Is the financial crisis over?
[Sighs] I'm sighing because that's a very tough question. I think that the extreme part of the crisis—the panic part—is past. The question now is, [what happens if] we don't recover as rapidly as some of the stock bulls would like?

How would you rate the Obama Administration's handling of the financial and economic crisis?
He's got a very smart team. I think they're doing the best they can in a situation that is unprecedented in terms of the lifetime experience of these people. I just think the variety and the number of the problems are more than any one Administration can handle in five or six months.

And this is petty and almost venal, but the idea that one Wall Street firm [Goldman Sachs] is the key to our stability and success is annoying to me. Goldman has emerged as very important. They've got some talented people. Historically, they were very smart, relatively faceless. They weren't like a Merrill Lynch or a Morgan Stanley in terms of their presence. They played it very cool, and they've insinuated themselves in all parts of the government. But are they perfect? Hell, no.

> "The idea that one Wall Street firm [Goldman Sachs] is the key to our stability and success is annoying to me"

Should investment banks and commercial banks be separate?
I thought that ending Glass-Steagall was a mistake. Commercial banks are very good for certain businesses, like loans and guarding other people's money. They're not great investors or entrepreneurs. Investment banks were a totally different bunch of animals.

But you can't re-enforce Glass-Steagall. That's ridiculous. There's going to have to be some new system. And where the hell has the Securities & Exchange Commission been?



"Mary Schapiro will be more aggressive" at the SEC than Cox, Gutfreund says

Well, it missed Madoff. Should the SEC be merged with another agency? The Commodity Futures Trading Commission, maybe?
I think they will merge over time. The SEC under Mr. [Christopher] Cox was a nightmare. Total passivity.

Will it change and get more aggressive under Mary Schapiro?
I think Mary Schapiro will be more aggressive. She's a more assertive regulator. The question is, will she get support? I don't see a lot of people standing up to say: "We're for Mary."

Should Congress be reining in pay on the Street or anywhere in business?
I was going to use a crude expression about Congress not knowing their something from their elbow, but I'm not going to. They're politicians. They are not very strong, practical people. I don't think they should be determining compensation. I was the highest-paid guy at a public company on Wall Street in 1982, and I earned a million dollars—nothing like the sums you hear about today.

How did compensation get so out of whack?
Because the ownership of the companies has no vote in what people get paid. The public shareholders have nothing to say about nothing. If they don't like it, they sell their stock.

Should some of these people who oversaw institutions that failed or were brought to their knees be asked to give back some of their compensation?
Don't hold your breath.

***BusinessWeek* proclaimed you the King of Wall Street 25 years ago. Is there a king these days?**
I wouldn't know him. I guess the king is Goldman Sachs.

MANAGING FORWARD/ THE RESET ECONOMY
Getting ready for the post-recession world

Which Wall Street firms are best positioning themselves for the future? And what will the future look like in financial services?
That's a nice little question. I think the firms that'll do best are the ones that have some commitment to serve shareholders as well as employees. You don't see that today. The average firm doesn't represent the public or the shareholders. The banks are putting in some Fancy Dans as directors, but they have no big equity interest. You have to find a way to balance the ownership and the producers. | BW |

Maria Bartiromo is the anchor of CNBC's Closing Bell and writes the blog, Maria Bartiromo's Investor Agenda, at investoragenda.cnbc.com

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NEITHER BORROWERS NOR LENDERS BE

Banks are still skittish about offering credit, and households and companies remain reluctant to seek loans—both of which will be drags on the recovery

In his detailed analysis of the events of the past year, presented in a speech on Aug. 21, Federal Reserve Chairman Ben Bernanke noted the substantial progress markets have made in healing the wounds from the financial crisis. But, as he was quick to add, the patient is far from healthy. "Strains persist" in many markets, he said. Institutions face "significant additional losses," and consumers and business still have "considerable difficulty" getting credit. The bottom line: Credit is not yet flowing sufficiently to assure a strong and sustainable recovery.

6.5%

Commercial bank delinquency rate for all loans and leases in the second quarter, a record

Data: Federal Reserve

The latest data from the banking sector highlight that point. Through mid-August, overall bank lending to consumers and businesses continued to contract. Over the past six months all loans and leases have declined at a record annual rate of 8%, with no hint of an upturn despite the Fed's massive efforts to get credit flowing again.

What's becoming clear is the two-sided nature of the problem that won't be resolved anytime soon. One side is the reduced willingness of banks to lend in a risky economic climate amid record loan delinquencies and charge-offs (page 26). The other is the subdued desire to borrow. Households are already saddled with enormous debt, and companies are hesitant to invest in expanding their operations. The Fed has done its best to lead the horse to water, as they say, but that's about it.

This dichotomy was evident in the Fed's latest survey of bank loan officers. The July survey continued to show that more banks had tightened their lending standards than had eased them, although the stringency was not as widespread as in the Fed's April survey and significantly less so than in January. A few banks actually eased terms and conditions in July, whereas none had done so in April. At the same time, the Fed said, loan demand, outside of prime mortgages, continued to weaken across all major categories.

The double whammy against credit growth is why the Fed will most likely keep its target interest rate near zero for a long time and why its flood of funds into the banking system will not spark inflation in the near future (page 28). The Fed's monetary fuel is meaningless until banks are willing to lend and people want to borrow. Right now, households are more interested in shedding debt amid lost wealth and sagging incomes, and banks want to invest in only the safest assets. Since February, bank holdings of Treasury and government agency securities have soared by $200 billion, while loans have shrunk by $295 billion (chart).

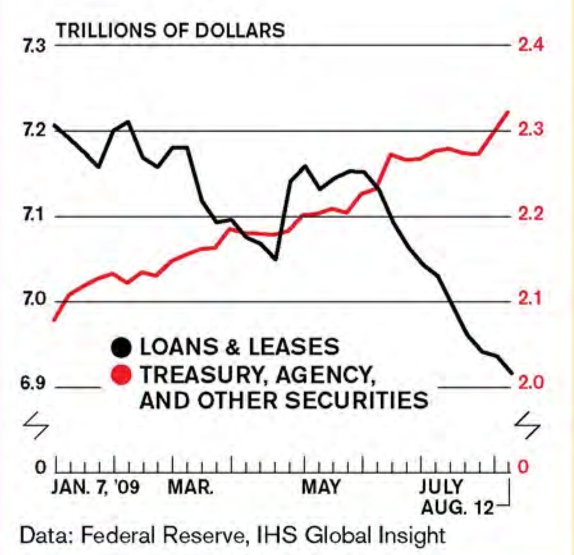
Banks are sure to remain skittish. Many say their lending standards will not return to normal for some time. For commercial and industrial loans to investment-grade companies, more than a third of banks said terms would stay tighter than average until the second half of 2010, according to a Fed survey. For prime residential and commercial mortgages, some 40% of banks said standards would be tougher than normal "for the foreseeable future."

Lenders are more cautious partly because they must increasingly hold on to the loans they make instead of packaging and selling them as asset-backed securities (ABSs). Thanks to the Fed's Term Asset-Backed Securities Loan Facility, securitization, which affects many types of consumer loans, is stirring again after a shutdown late last year. But ABS issuance in the second quarter remained 23% below the year before and 72% below two years ago.

The good news is that bank loans account for only about 30% of debt held by households and nonfinancial businesses. In the broader financial markets, credit flows have improved notably in recent months, especially corporate borrowing. Corporate bond issuance, for both investment-grade and high-yield bonds, is running well ahead of last year.

As Bernanke, now nominated for a second term, has pointed out, the drag from the credit crunch is diminishing. But credit growth is a dance for two, and right now lenders and borrowers are still far apart. | BW |

HOW BANKS ARE USING THEIR FUNDS



Data: Federal Reserve, IHS Global Insight

BRAD TRENT; CHART BY LAUREL DAUNIS-ALLEN/BW

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The next
50%
add nothing.

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20%?

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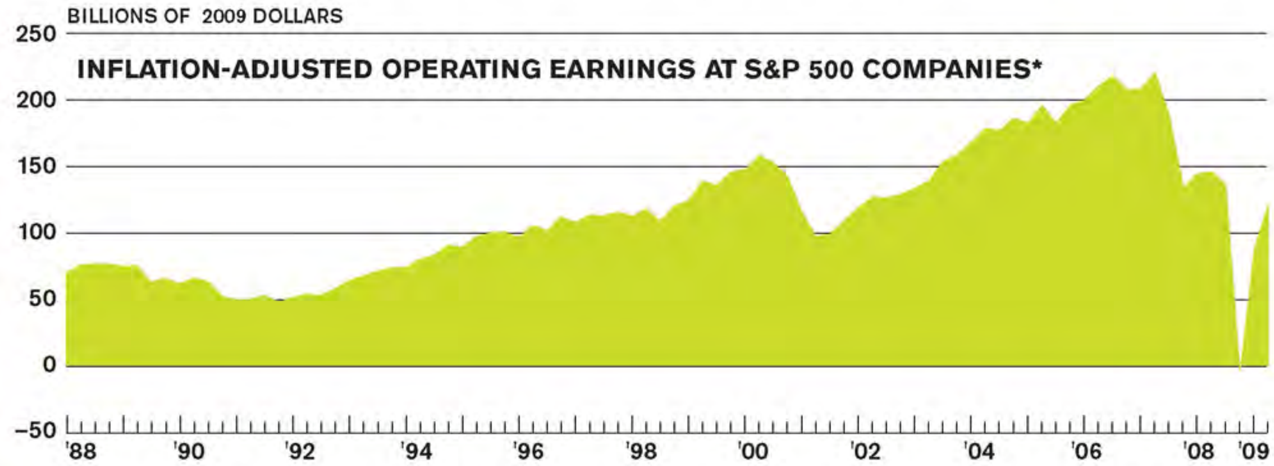
NUMBERS

PROFITS PERK UP AT LARGE U.S. COMPANIES

By Tara Kalwarski/Charts by Laurel Daunis-Allen

Companies in the Standard & Poor's 500-stock index reported operating profits of $122 billion in the second quarter—much better than the inflation-adjusted losses of $800 million reported for the fourth quarter of 2008. But earnings remain down from a year earlier, and many sectors have yet to see profit margins improve.

Making money again: Real operating earnings at big U.S. companies have climbed back to levels first hit in 1998.

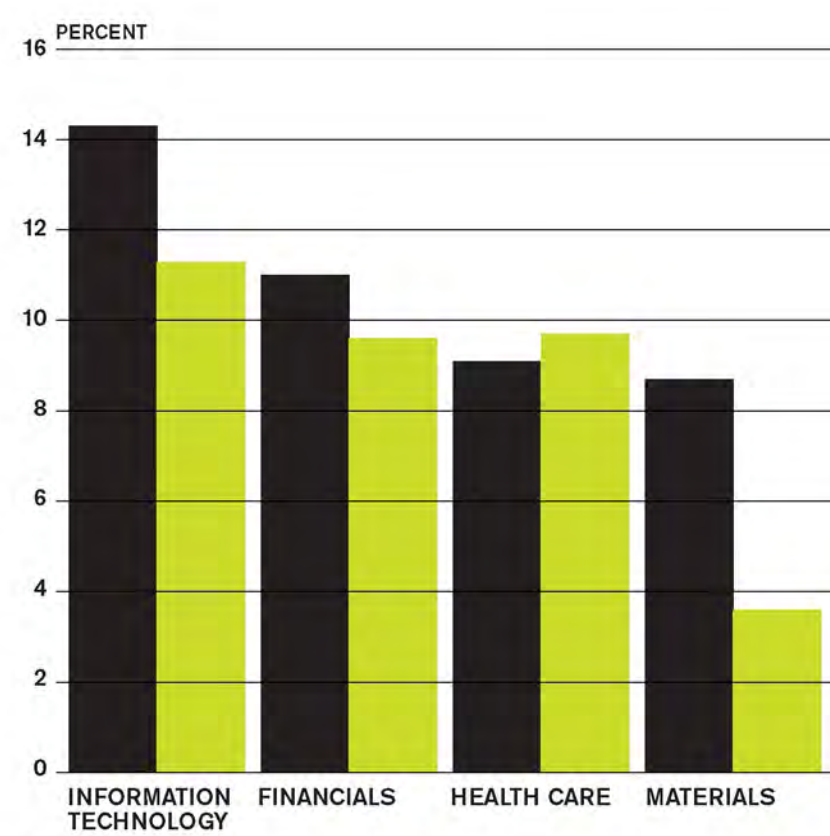


Data: Standard & Poor's, Bureau of Labor Statistics

*Q2 '09 is estimated

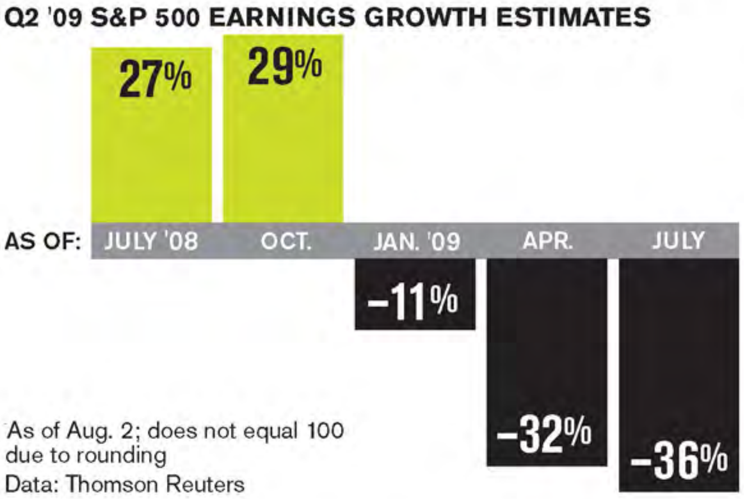
WHERE MARGINS ARE GETTING FATTER

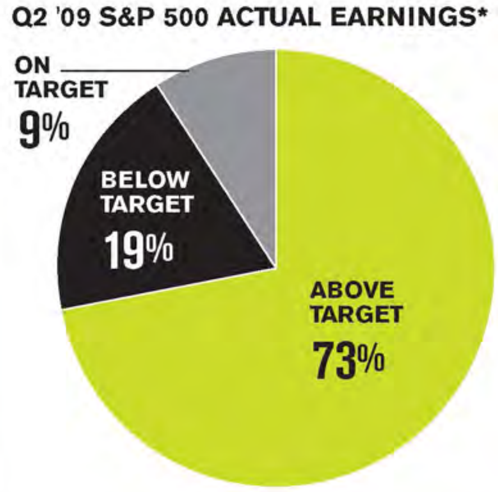
Profit margins at health-care, utility, consumer staples, and consumer discretionary companies have actually improved in the past year.



Data: Capital IQ

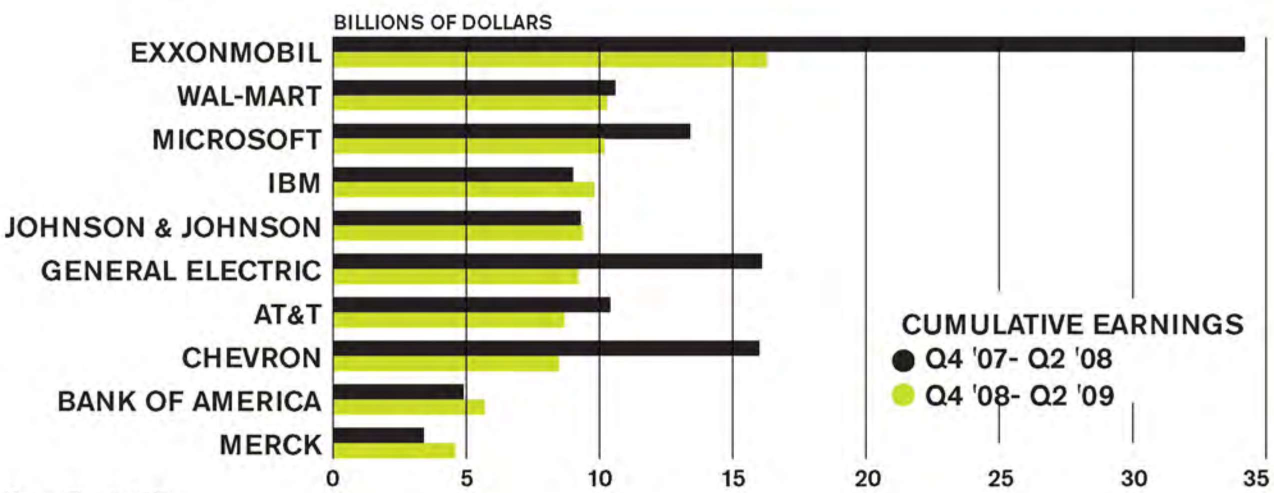
Faint praise: The majority of S&P 500 companies have surpassed earnings targets. But that's not saying much, since expectations had fallen so low.



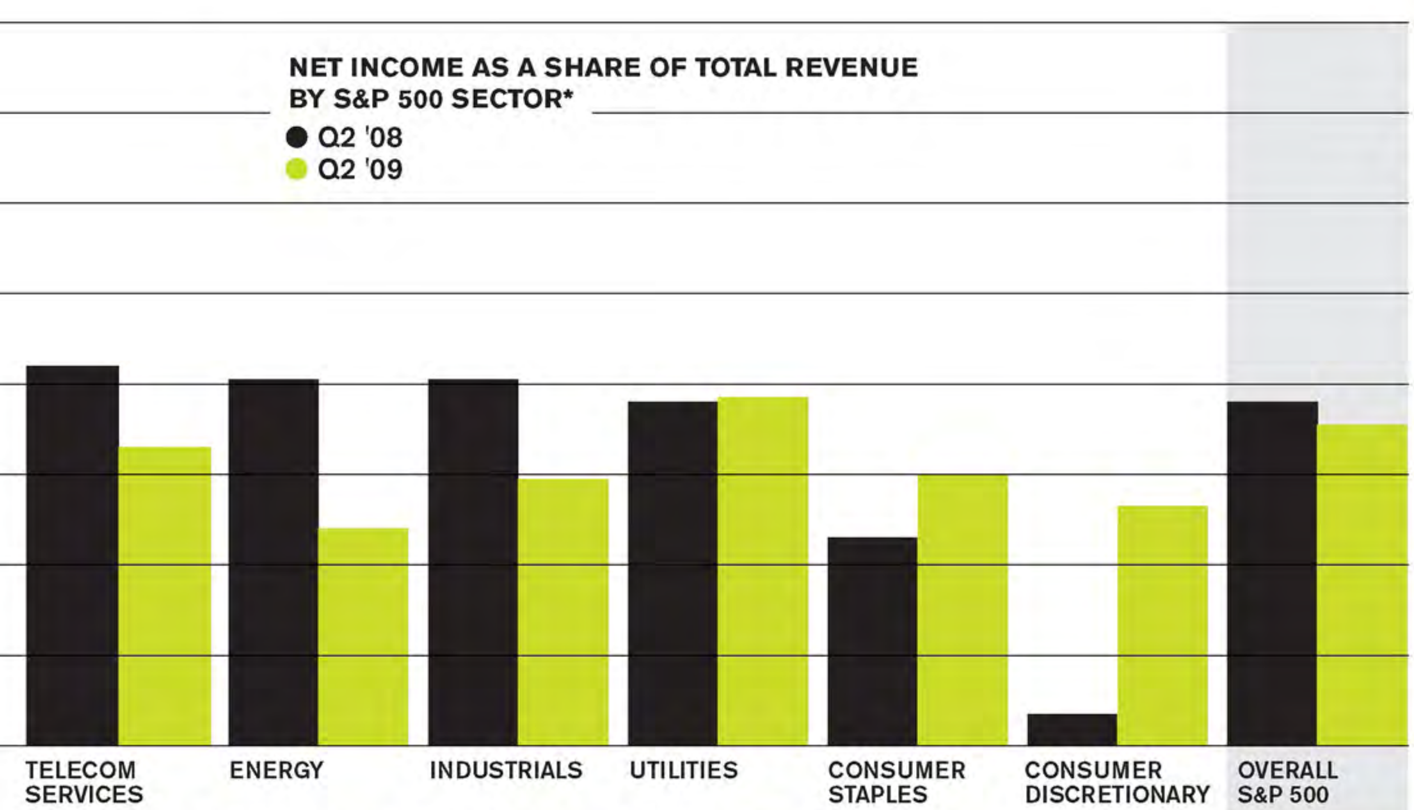


As of Aug. 2; does not equal 100 due to rounding
Data: Thomson Reuters

Playing catch-up: Net income reported by many of America's most profitable companies remains below year-earlier levels.



Data: Capital IQ



*Calculated for the 465 S&P 500 companies that had reported Q2 2009 earnings as of Aug. 17

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ZOHAR LAZAR

BLACKBERRY'S BOSS IS ICED BY THE NHL

Like many Canadians, Research In Motion co-CEO Jim Balsillie is a tad obsessed with hockey. He plays right wing in a pickup league and named all the conference rooms in his office building at RIM's Waterloo (Ont.) headquarters after the game's greats.

Now, Balsillie is brawling with the National Hockey League over whether he can acquire an NHL team. Balsillie, worth $2.5 billion, has offered $213 million to buy the Phoenix Coyotes out of bankruptcy and move the team to Hamilton, a city of 500,000 near the BlackBerry maker's offices. But the NHL doesn't want another team squeezed between those in Toronto, Buffalo, and Detroit, and it says Balsillie lacks the "good character and integrity" to be an NHL owner.

Them's fighting words for Balsillie. In a bankruptcy court filing, he says any character flaws he has pale in comparison with those of others in a league that "has long tolerated indicted and even convicted criminals among its ranks." He also thinks Hamilton is the ideal market for a hockey franchise, given the region's enthusiastic fans. "It's the largest unserved hockey market in North America," he says.

The move to Arizona hasn't worked out financially. Once the Winnipeg Jets, the team left for Phoenix in 1996 as part of NHL Commissioner Gary Bettman's strategy to broaden hockey's appeal. With tepid fan support, the team has lost $300 million since the move.

Although Hamilton is an hour south of Toronto, Balsillie says there's plenty of fan support for two teams. He points out that the wait for the Toronto Maple Leafs' season tickets can stretch more than a decade.

The Coyotes owner wants to sell to Balsillie. But the NHL is taking the unusual step of offering to buy the team itself for $140 million, with plans to resell it to another owner in the future. An Arizona bankruptcy judge will decide if Balsillie's bid can go forward on Sept. 2. If he loses, the NHL will likely hear from him again. "I've been approached by other owners" looking to sell, Balsillie says. *–Arik Hesseldahl*



FACEBOOK FOGIES

Facebook started out in 2004 as an online hangout for college students. Now it looks like the baby boomers are crashing the party. Membership on the social-network site of U.S. users age 55-plus shot up 25%, to 7.3 million, in the one-month period ending Aug. 4, according to Washington researcher iStrategyLabs, which collects data Facebook gives to advertisers. That's more than triple the rate of growth for all U.S. users on the site in the same period. Older Facebook users now represent about 10% of the total 77.7 million registered with the site in the U.S., according to iStrategyLabs data.

The graying of Facebook has been under way for some time, but it really accelerated this year. During the first half of 2009, the number of people in their 50s on the site "more than doubled," notes Facebook spokeswoman Brandee Barker. "Most likely the trend started with younger people convincing their parents and grandparents to engage," says Danah Boyd, who tracks social media for Microsoft Research. And the dramatic increase in this demographic group may be the result of these early converts spreading the social-networking religion among their peers.

Older members find the site a convenient way to rekindle bygone friendships. Christine Drost, a 55-year-old nurse who lives in Randolph, N.J., decided to join in early August after finding out her old friends from a drum corps she played with more than 30 years ago had started a group on the site. "That was the final push I needed," says Drost, who now uses the site to share pictures and update friends and family on her whereabouts.

Boomers are also attracting new advertisers, such as Dove and 1-800-FLOWERS.com, to Facebook, which relies on ads for the bulk of its estimated $500 million in revenue.

Will younger users flee Facebook when they realize mom and dad might be peering over their shoulders? In an effort to help the generations coexist on the site, Facebook announced in July it's testing new privacy controls that will permit members to choose exactly who's allowed to see each message they post.

–Douglas MacMillan

WILL CHINA PICK UP THE OPHONE?

Pity the gadget-hungry consumer in China. If you want an iPhone, you have to go to the black market, since Apple hasn't been able to negotiate a deal with a Chinese carrier to sell legitimate versions of the handset. Now, China Mobile—which tried but failed to reach a deal with Apple—has an alternative pitch for customers seeking cachet: Try an OPhone.

The mainland's top operator hopes consumers won't care about the one-vowel difference. By yearend, China Mobile plans to roll out several different OPhones, 3G handsets based on Google's Android software. Among the players working with China Mobile are Dell, Philips, LG, Samsung, and Taiwan's HTC. "The problem we have is not the 3G network, but rather a lack of cell phones that can support it," China Mobile Chairman Wang Jianzhou said on a visit to Taiwan to announce a partnership with HTC.

China Mobile could use a boost. With 493 million subscribers, it has more than 70% of the local cellular market, ahead of China Unicom and China Telecom. But it's facing more heat since Beijing let 3G networks into China early this year. Apple had no comment. *–Bruce Einhorn in Hong Kong*



An ad for China Mobile

ILLUSTRATION BY ZOHAR LAZAR; PHOTOGRAPH BY MARK RALSTON/AFP/GETTY IMAGES



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CEO PAY: IS IT STILL OUT OF SYNC?

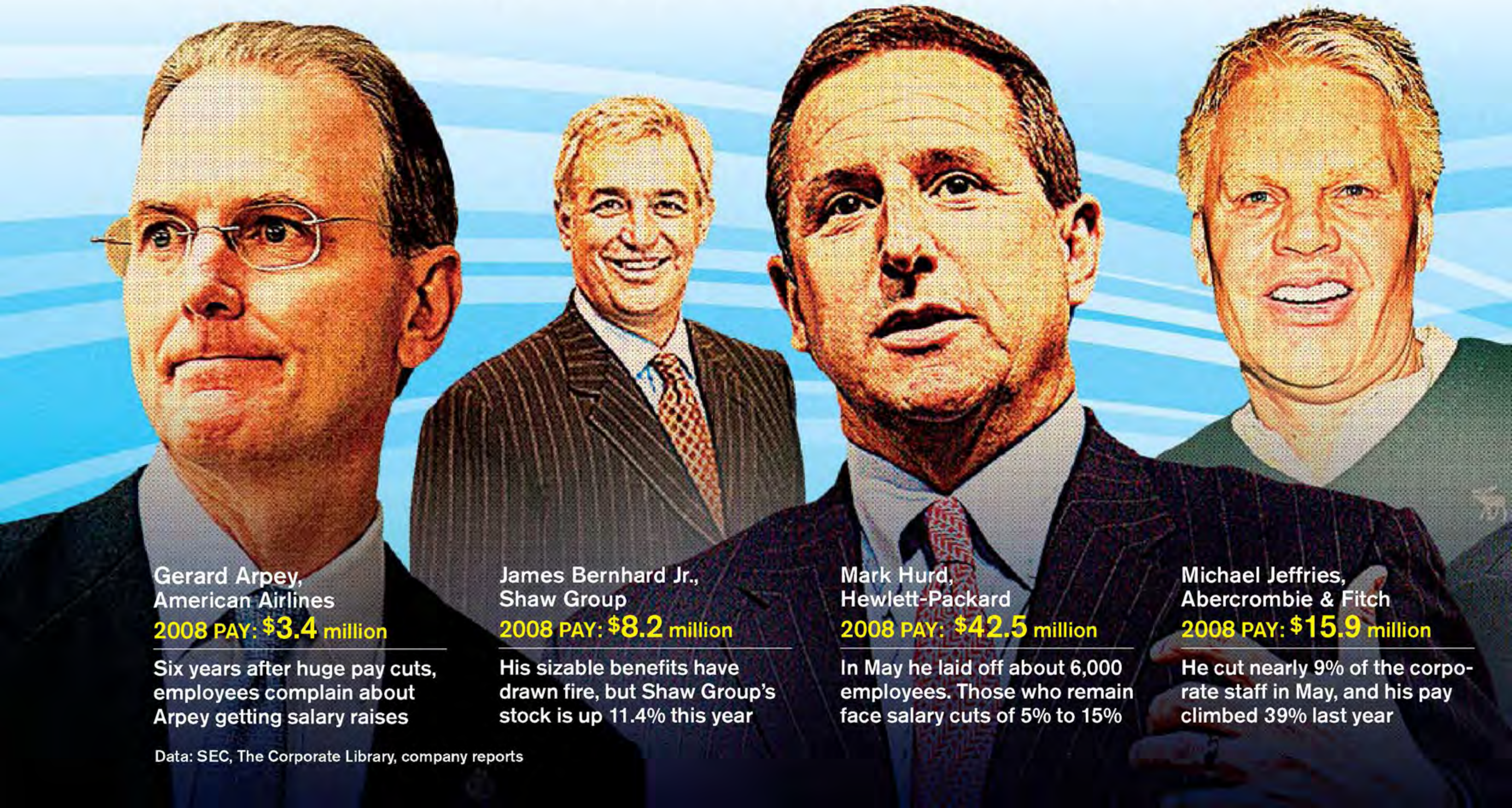
Even in the midst of painful downsizings, many boards are handsomely rewarding bosses

By Nanette Byrnes and Jena McGregor

It has been a tough year for the American worker, with unemployment hovering near 10% and cuts in pay or benefits for many of those who still have their jobs.

But one category of worker is still doing pretty well: the chief executive officer. Job stability has improved for corporate leaders since the recession began (page 24). And many still enjoy hefty compensation even as they cut the salaries and positions of their staffs.

To be sure, many leaders are sharing the pain. Total compensation for the average CEO at an S&P 500 company declined last year by 7.5%, or $700,000, according to data tracker Equilar. And executives such as General Electric's Jeffrey R. Immelt have declined their bonuses, while the CEO of bailed-out Citigroup, Vikram Pandit, has sworn to take no more than $1 per year until the bank returns to profitability. Charles G. Tharp, executive vice-president for policy at the



Gerard Arpey, American Airlines
2008 PAY: $3.4 million
Six years after huge pay cuts, employees complain about Arpey getting salary raises

James Bernhard Jr., Shaw Group
2008 PAY: $8.2 million
His sizable benefits have drawn fire, but Shaw Group's stock is up 11.4% this year

Mark Hurd, Hewlett-Packard
2008 PAY: $42.5 million
In May he laid off about 6,000 employees. Those who remain face salary cuts of 5% to 15%

Michael Jeffries, Abercrombie & Fitch
2008 PAY: $15.9 million
He cut nearly 9% of the corporate staff in May, and his pay climbed 39% last year

Data: SEC, The Corporate Library, company reports

Center on Executive Compensation, says "companies are making sure they are aware of risk and incentives."

But there are some notable exceptions: Michael Jeffries of Abercrombie & Fitch saw his pay climb 39% last year, even though the retailer's stock fell 72% and it has trimmed staff. (Abercrombie declined to comment.)

Directors face a difficult balancing act amid the recession. They must retain top executives and reward those who make the hard choices that will boost the bottom line. Often that means job cuts and labor concessions.

But directors also need to be sensitive to perceptions. Problems can emerge when leaders appear to be reaping high rewards at a time when they're demanding sacrifices from their workers. Wharton School professor Peter Cappelli says such moves can seem "patently unfair" and argues they can undermine morale. Umesh Ramakrishnan, vice-chairman of executive recruiter CTPartners, says many senior executives still view their pay primarily in light of "how they will be perceived as ranking vis-à-vis their peers, and how that will affect their next move." Even though some CEOs seem focused on staying ahead in the pay stakes, leadership guru Warren Bennis warns that "employees are extraordinarily wary and watchful" right now.

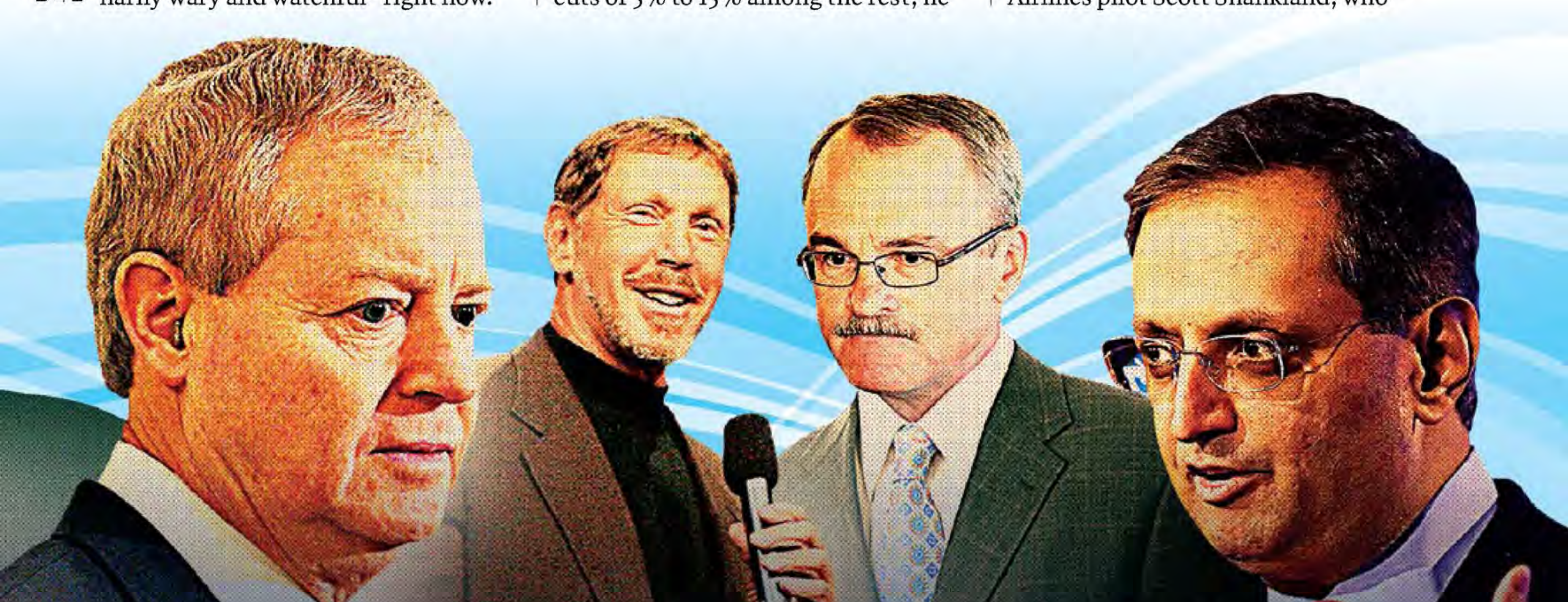
Consider ConocoPhillips. In January, CEO James J. Mulva cut 4% of the Houston oil giant's workforce. Two months later the company announced that Mulva had earned $29 million in 2008, on top of nearly $100 million he had made in the two prior years. In Bartlesville, Okla., where a chunk of the layoffs hit, many are still looking for work. The fact that Mulva took a $10 million stock grant in 2008 instead of the $38 million he got the year before hasn't been much comfort to former employees there, some of whom lost their homes. Conoco did not respond to repeated requests for comment.

NOT ENOUGH

Many of the recent headlines about CEO compensation have focused on companies like American International Group and Merrill Lynch, where bailout money hasn't stopped big bonuses. But even at far healthier companies there is resentment over executive pay. Hewlett-Packard CEO Mark V. Hurd's total compensation last year was $42.5 million, thanks in part to a three-year package that paid out last year. With HP stock up 22% this year, vs. about 14% for the S&P 500-stock index, many would say he's on the right track. Hurd laid off about 6,000 employees in May and imposed salary cuts of 5% to 15% among the rest; he also took a 20% salary cut in 2009.

For some, that's not enough. Richard Tauchar, a systems engineer for EDS, acquired by HP last year, says some employees were not reassured by Hurd's salary cut. "In reality, he's not sharing the pain," he says. And it bothers Tauchar that CEOs are getting richly rewarded—justifiably so, investors might argue—for cutting costs at the expense of colleagues. "Executives aren't merely making their millions while paying employees less," he argues. "They are making their millions because they have chosen to pay employees less." Through a spokesperson, HP and Hurd declined to comment.

One way to gauge the long-term impact of such moves is to look at morale in the airline industry, which has been battling economic woes for years. In 2003 workers at American Airlines took pay cuts of up to 50% in an effort to save the carrier from bankruptcy, a move that management sold in part through an internal slogan "Share the Pain, Share the Gain." Now pilots, mechanics, and others say they've only seen the pain, a perceived double standard they think is starting to affect employee performance. "It's hard to be motivated to go above and beyond your normal duties when you don't feel appreciated at work," says American Airlines pilot Scott Shankland, who



James Mulva, ConocoPhillips
2008 PAY: $29.4 million
Despite a $34 billion write-down, he got a bonus in '08, before 4% of staff was cut

Lawrence Ellison, Oracle
2008 PAY: $56.8 million
Recently agreed to a $1 salary for 2009, though most of comp comes from option grants

Ronald Sargent, Staples
2008 PAY: $8.4 million
The company has made it easier for executives to get a bonus next year

Vikram Pandit, Citigroup
2008 PAY: $10.8 million
With 52,000 jobs shed at Citi, he is taking $1 a year until the company turns a profit

PHOTO ILLUSTRATION BY SEAN MCCABE; PHOTOS (L-R) MATT NAGER/BLOOMBERG NEWS; PRNEWSFOTO/MIRANT CORPORATION; JUSTIN SULLIVAN/GETTY IMAGES; MICHAEL LOCCISANO/FILMMAGIC FOR PAUL WILMOT COMMUNICATIONS; DANIEL ACKER/BLOOMBERG NEWS; ROBERT GALBRAITH /REUTERS; NEAL HAMBERG/BLOOMBERG NEWS; JIM WATSON/AFP/GETTY IMAGES

also acts as a spokesman for the pilots' union. In recent years, American's record of on-time arrivals has slid, as has customer service.

Meanwhile, Gerard J. Arpey, CEO of American Airlines parent company, AMR, has seen his base salary rise every year since 2005, though he won't this year. Shankland says pilots are working, on a wage-adjusted basis, for the same amount they were in 1992 while the airline's executives have received $330 million in stock grants and option awards since 2005. And by the end of this year, the airline will have laid off as many as 1,600 workers. Still, company spokesperson Missy Latham says that American's rank-and-file are highly paid compared with peers while executives are not, and management has worked hard to minimize layoffs.

LONG-TERM COSTS?

While it's difficult for employees to take home less money, especially when they meet their targets, even the perception of inequity can damage a company. Organizational psychologist Ben Dattner argues that "concerns about employees and retention and organizational culture have been pushed aside by the demands of the global economic crisis." Once the economy stabilizes, he says, leaders who put themselves first may see a talent drain. Costco Wholesale CEO James D. Sinegal has received the same $350,000 salary since 1999 (his total 2008 package, according to the company's proxy, was $4.9 million). Sinegal says that keeping a long-term focus requires satisfying employees with pay levels that seem fair. "They feel better about their company and where the company is going if they know ...someone is not just raking everything off the top."

This year will be the true test of the equity of CEO pay, says Edward E. Lawler III, director of the Center for Effective Organizations at the University of Southern California's Marshall School of Business. If the stock market's recent gains hold up, CEOs "may be the only people who've come through the downturn in good shape," he says. | BW |

-With Brian Burnsed in New York and Theo Francis in Washington

SAME OLD FACES IN THE C-SUITE

CEO turnover has slowed as risk-averse boards hang on to their corporate chiefs



By Jena McGregor

When Abraham Lincoln and Franklin D. Roosevelt campaigned for reelection during wartime, they told voters it was a bad idea to switch leaders midstream. Today, CEOs seem to be convincing their boards of the same thing.

Despite heavy layoffs in the lower ranks this year, job stability has been higher in the C-suite, creating yet another disparity between executives and their workers. Of course, there have been notable exits, such as Rick Wagoner at General Motors and Jerry Yang at Yahoo! But executive search firm Spencer Stuart reports that turnover has slowed to just 26 CEO changes among the Standard & Poor's 500 companies during the first half of 2009, compared with 36 for the same period last year.

Broaden the universe to some 13,000 public companies and there are double-digit declines in CEO job shifts, according to Liberum Research, which tracks management changes for hedge funds. "That's kind of counterintuitive" for a recession, says Richard Jacovitz, Liberum's director of research. "As companies cut back, you would think that top executives would get impacted, too."

One reason is that leaders have fewer places to go. With private equity firms licking their wounds, few executives are being poached to run portfolio companies. The volatile environment has also made directors skittish. When the economy soured, notes Korn/Ferry International Vice-Chairman Joe Griesedieck, "A lot of boards pulled in their horns and said, 'let's stick with our guy through the tough times.'"

MASKING MEDIOCRITY

But that means middling performers may get cut more slack. Matthew V. McGreal, a principal at search firm Crist/Kolder Associates, says: "It's perceived that the greater risk is to make the move" unless performance is "atrocious." And tough times tend to mask mediocrity. Says Nell Minow, co-founder of the Corporate Library, which researches governance: "Just as the rising tide lifts all boats, the ebbing tide makes everyone look equally bad."

Boards aren't the only ones taking fewer risks. Recruiters say CEOs are less inclined to seek out new positions—at least now. Minow believes that may be because of moves to increase retention bonuses and stock grants. "As long as everyone's fat and happy, why should they leave?" she asks. "If we're taking the downside out of the pay package, gee, I'd stay too." | BW |

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ARE BANKS PLAYING IT TOO SAFE?

Critics say capital cushions at firms like Goldman are a drag on profits, and healthy banks need more leverage

By David Henry

Barely a year after Lehman Brothers toppled under the weight of its own debt, Wall Street is calling for some players to load up again. Analysts say Goldman Sachs, Morgan Stanley, JPMorgan Chase, and other relatively healthy firms are holding too much capital—an overly cautious stance that's costing shareholders billions of dollars in profits.

It's a tricky balancing act. Banks, which set money aside to protect against losses, have more capital than regulators require. They would love to use some of that extra cushion to boost dividends, buy back shares, or borrow more money to invest. But the economy and credit markets remain fragile. And the Obama Administration wants to raise the capital requirements. "You've got two opposing forces: the regulator turning the screws, and investors saying you need more leverage," says a financial lobbyist.

How this tension between Washington and Wall Street plays out will influence whether the financial system takes on too much or too little risk, a critical factor in a recovery. If the pendulum swings too far in the risky direction, the banks may not be able to withstand another round of losses, a shock that could send the economy into a downward spiral. If it swings too far in the other direction, the banks may starve the economy of the credit it needs to grow.

The tension is most palpable at Goldman. Critics have slammed Goldman's aggressive trading style, which produced outsize profits in recent quarters. But when it comes to capital and leverage, Goldman has actually been quite prudent. And in the firm's latest conference call, 7 out of 17 analysts pushed management to bolster risk on the balance sheet. "There's a broad belief among investors that they are running with higher levels of capital than they need," says Roger A. Freeman, an analyst at Barclays Capital. Goldman declined to comment.

The conservative posture crimps profits. Consider Goldman's mix of assets. The firm has $171 billion, 19% of assets, in cash and highly liquid investments. The pile protects the firm in case of a panic but yields next to nothing. And it's double the stash that Goldman has had in the past. If the firm moves just $70 billion into securities earning 2%, it could boost annual profits by 5%, or $500 million, according to a report by Guy Moszkowski, an analyst at Bank of America Merrill Lynch.

Then there's the firm's leverage. By loading up on short-term debt and investing the proceeds in higher-yielding securities, banks can amplify their profits. Goldman currently owns $14 of assets for every $1 of capital, or 14 times its capital—roughly in line with peers. Nobody is saying Goldman and others should borrow to the max the way they did during the boom, when

THE THICKEST CUSHIONS

Big banks with the highest amounts of capital

COMPANY	CAPITAL (% OF ASSETS)*	COMPANY	CAPITAL (% OF ASSETS)*
State Street	12.54%	American Express	9.60%
Bank of New York Mellon	11.10	BB&T	8.40
Goldman Sachs	10.90	JPMorgan Chase	7.70
Morgan Stanley**	10.60	U.S. Bancorp	6.70

*Tier 1 Common Capital as of June **Uses a different formula to calculate capital Data: SNL Financial

TOMASZ WALENTA

assets topped 25 times capital. But during more typical years, the figure has hovered around 20 for Goldman. Moszkowski figures the firm could add $2 a share to profits with an extra dose of leverage.

Despite its recent strong showing, Goldman needs to pump up profits. The firm has committed to delivering a 20% return on equity (a measure of profitability) over each business cycle. Historically, it has been able to meet the target, ensuring a lofty share price and loyalty from employees, who receive a lot of their pay in stock. But earnings sank in 2008, and Goldman fell way short of its goal. To offset the weak performance, it needs some bonanza years. The easiest way? Ramp up risk.

But Goldman may be constrained by the credit markets. The bank, like its peers, can't easily borrow unless creditors have faith in its ability to repay the money. Those banks, debt investors, and other creditors can be capricious, willing to lend one moment and reluctant the next. For example, the price of Goldman's credit default swaps, essentially insurance policies against default, shot up in August after falling for five months. It's a sign, says Tim Backshall of Credit Derivatives Research, that creditors may be spooked about the prospect of rising leverage.

Washington is another big obstacle. In a June report, the Treasury Dept. called for stronger "capital and other prudential standards." A committee is expected to recommend changes by January. The biggest banks will have "to meet stronger capital and liquidity requirements so that they're more resilient and less likely to fail," President Barack Obama said at the time.

Goldman doesn't seem willing to provoke the ire of Washington. In the July conference call, Goldman Chief Financial Officer David A. Viniar told analysts: "We don't know what the [new regulations] will be, so we'll have to wait and see." It's a sentiment echoed across the industry. Michael J. Cavanagh, CFO at JPMorgan, lamented in a call that the bank didn't need the $5 billion the government forced it to raise as a condition of repaying the bailout funds. Morgan Stanley CFO Colm Kelleher told analysts: "We have internal targets [for leverage], but I can't give [them] because I'm really subject to what my regulators would like me to do." |BW|

–*With Theo Francis*

Business Exchange

Read, save, and add content on BW's new Web 2.0 topic network

The Fed's Problem

The Federal Reserve is on a spending spree, reports Heidi N. Moore, a contributor at *The Big Money,* a Web site. In the past four weeks alone, the central bank has purchased $67 billion in mortgage securities, helping create demand in the market. But with so much bad debt on its books, the Fed "may be in over its head."

To read the full column, go to **http://bx.businessweek.com/federal-reserve/reference**

天津滨海新区 - 中国经济发展新的增长极

Tianjin Binhai New Area: New Growth Pole of Chinese Economic Development

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The leading industries, including electronics information, petroleum and marine chemical, automobile and equipment manufacturing, modern metallurgy, biotechnology and modern medicine, new materials, and energy and food processing, have been well developed in Binhai New Area, and new leading industries, such as aviation and aerospace industry as well as service outsourcing industry are on the upsurge.



LOW RATES AS FAR AS BERNANKE CAN SEE

Why the Federal Reserve policy of keeping short-term interest at historic lows has such broad support



If confirmed by the Senate, Bernanke's term would run through 2014

By Peter Coy

It's remarkable, really. The Federal Reserve is holding short-term interest rates at the lowest levels in history—zero to 0.25%—even though the economy is showing signs of recovery. Some critics argue these ultra-low rates will trigger a dollar crisis or fuel financial speculation that will end, once again, in tears. Yet the engineer of these low rates, Fed Chairman Ben Bernanke, has retained the confidence of the financial markets and fellow policymakers. On Aug. 25, President Barack Obama said he will reappoint Bernanke to another four-year term as chairman. If confirmed by the Senate, he would remain at the helm through January 2014.

How has Bernanke managed to win support for keeping interest rates at rock bottom, even though the easy-money policy he advocated in 2002-04 helped inflate the bubble that burst disastrously just a few years later? The answer is simple: Bernanke has succeeded in persuading most fellow economists—and, crucially, the bond market—that continued low rates pose no immediate risk of inflation and are in fact essential to keeping the U.S. economy from suffering a double-dip, W-shaped recession.

Not a single member of the rate-setting Federal Open Market Committee—which includes inflation hawks such as Richmond Fed President Jeffrey M. Lacker—dissented from the August vote to maintain low rates. Bernanke's grip on policy has only been strengthened in recent days by Obama's endorsement as well as support from other central bankers at the Fed's August conclave in Jackson Hole, Wyo.

Bernanke has persuaded many that low interest rates are essential to keeping the economy from a W-shaped recession

Despite chatter about the Fed's urgent need for an "exit strategy," traders in the money market expect the funds rate to remain at 0.25% or below through next January or March before drifting up to 1% by summer, according to data from Bloomberg. And the likelihood of continued cheap money isn't alarming the bond market, which hates inflation. Yields on 30-year Treasuries have fallen slightly over the past month. Rates on inflation-protected Treasuries show no signs of mounting inflation anxiety.

Sure, it's easy to find people who think Bernanke needs to hike rates. Peter Schiff, president of brokerage Euro Pacific Capital, says that by nominating Bernanke for another term Obama is "rewarding failure," adding that "the cost [of low rates] will be a major currency crisis which undermines what remains of our economy." John E. Lekas, senior portfolio manager of the Leader Short-Term Bond Fund, argues that the Fed will be forced to raise short-term rates drastically in the next two years to keep foreign creditors content and prevent a dollar collapse.

But David G. Blanchflower, a Darmouth College economist who was until June a member of the Bank of England's Monetary Policy Committee, says Bernanke is correct to believe the global financial crisis remains dangerous. "It ain't over, babes," says Blanchflower.

LICENSE TO CONTINUE

On Wall Street, few economists or traders worry that rates need to rise soon. Excess capacity will keep a lid on prices for a long time to come, says Larry Kantor, head of research at Barclays Capital in New York. The Fed doesn't need to raise rates to defend the dollar, either, because the recession has actually reduced net U.S. borrowing needs, says JPMorgan Chase chief economist Bruce Kasman.

With an implicit endorsement from the bond vigilantes—and now an explicit one from the President—Chairman Bernanke has the license to pursue his low-rate policy for as long as it takes to get the American economy back on track. | BW |

JEWEL SAMAD/AFP/GETTY IMAGES

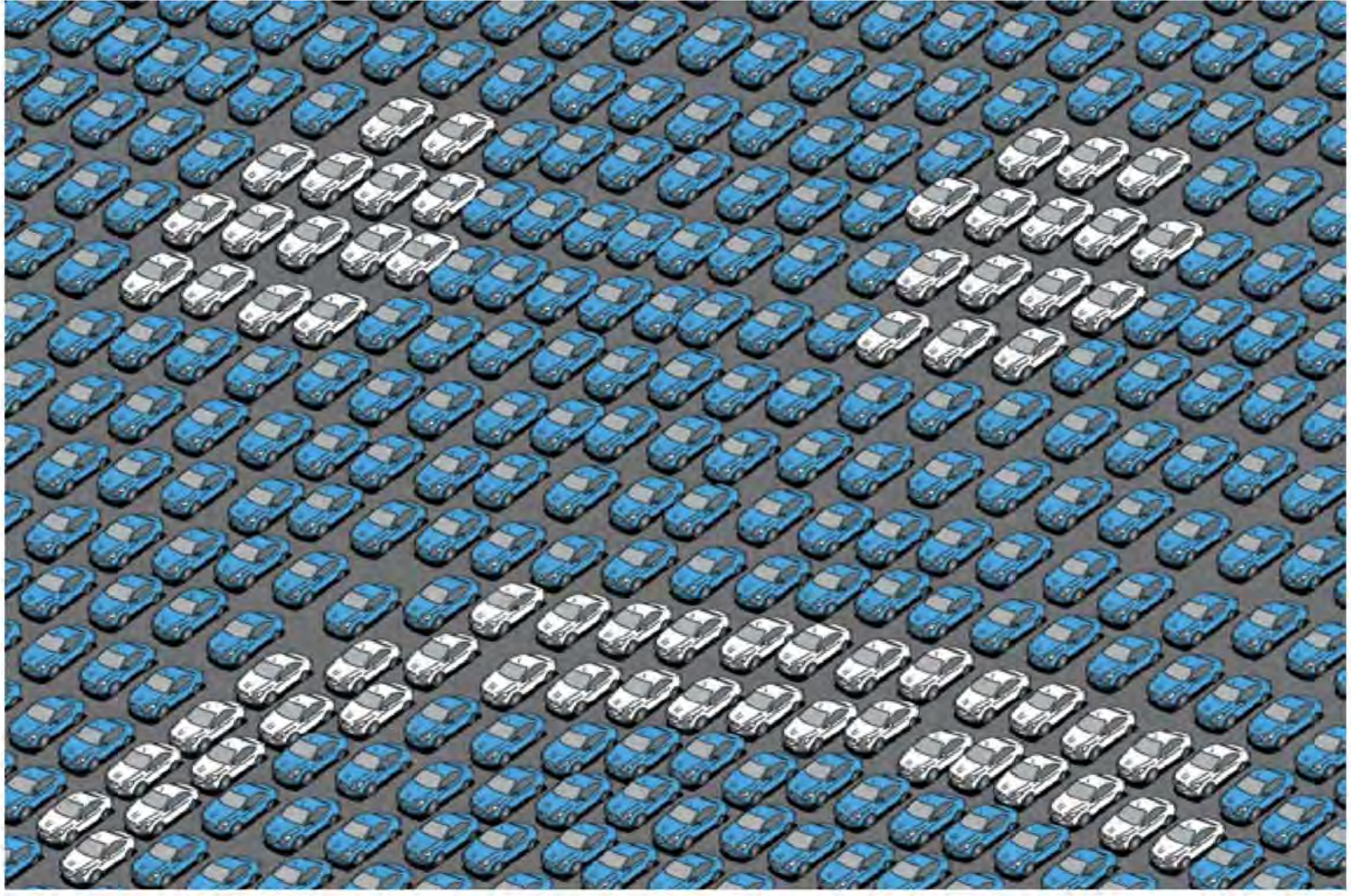
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AMERICA'S FICKLE SMALL-CAR MARKET

In the next 18 months, automakers are launching more than nine models. But will they sell without incentives?

By David Welch

If the cash-for-clunkers program proved anything, it's that with the right kind of financial incentive, Americans will buy small, fuel-efficient cars. Armed with rebates of up to $4,500 from the federal government, consumers snapped up such models as the Honda Civic and Ford Focus. They did pretty much the same thing last summer when gasoline prices in the U.S. roared past $4 a gallon.

And what happens when the incentives go away? Small-car sales typically tank. That presents a problem for automakers. Over the next 18 months, more than nine all-new compacts and subcompacts will arrive. With the clunker program over, and gasoline expected to stay below $3 for the foreseeable future, carmakers could be forced to dangle discounts before buyers. That would hammer per-car profits, especially for Detroit.

It is hard to make decent money on small cars unless you have a long history of selling them. U.S. automakers do not, and it was instructive to see what happened to General Motors when high gas prices created a miniboom in these vehicles last summer. In May 2008 gas prices hit a national average of $3.76, and small-car sales surged six percentage points, to 17% of the U.S. market. Suddenly GM had decent economies of scale: Cars that once lost as much as $3,000 apiece were closer to break-even despite discounts of up to $900 each.

$1,900

Average incentive from automakers to move compact cars in the cash-for-clunkers program

Data: Edmunds.com

But the gas price shock had worn off by August (though oil prices didn't begin their historic retreat for a few more months), and small car sales slumped. Before long, GM was forced to furlough the third shift at its Ohio small-car plant, added only five months before.

Carmakers badly want to believe that Americans like small cars. Eric Noble, president of The CarLab, a consulting firm in Orange, Calif., says European and Asian carmakers have hired him to do consumer research on small-car demand. When consumers gave them the thumbs-down, the clients asked him to rewrite the questions to see if that would change the result. It didn't.

Besides believing small cars to be unsafe and cramped, Americans also see them as rides for people who can't afford better. So carmakers are loading up small models with creature comforts and technology in the hopes of winning customers and charging them a premium. Ford's Focus compact and Fiesta subcompact will feature hands-free calling and navigation and the so-called SYNC system that lets drivers load music onto an in-dash hard drive.

Ford says the new SYNC-equipped Focus will fetch $2,000 more than the old one. "Small cars have been appliances in the U.S. for the most part, but we've seen you can get better prices if you make them exciting and functional, as well as fuel-efficient," says Ford CFO Lewis Booth. GM's Buick compact will feature leather seats, electronic gadgetry, and a Lexus-smooth ride. Kia has made satellite radio and hands-free phone technology standard in its Forte compact.

While the clunker program drove buyers into showrooms, carmakers still needed to spend about $1,900 per compact to help spur sales, according to Edmunds.com. If the coming wave of small cars doesn't wow Americans, U.S. automakers will be duking it out on price with their better-positioned rivals. And those minicars could lead to megalosses. |BW|

–With David Kiley

PETER ARKLE

CHINA: BOOMING CAR SALES, TINY PROFITS

The small, inexpensive autos favored in the soon-to-be No. 1 market make it tough to make a buck


DOUG KANTER/BLOOMBERG NEWS

Low-priced Wuling vans make up the bulk of GM's sales in China

By Ian Rowley

These look like fat times for carmakers in China. Since January, when Beijing introduced measures to shore up the auto industry, sales in the mainland have jumped 23%, and for the year the increase could hit 26%, Hong Kong-based brokerage CLSA reckons. That would mean 2009 sales of 11.8 million vehicles, making China the world's top auto market. "I think China has taken over [the No. 1 spot] for good," says CLSA analyst Scott Laprise.

The problem, at least for carmakers, is that those surging sales don't produce the kind of profits most companies want. China's stimulus package included tax breaks on cars with small engines and subsidies for mini-trucks. Through July, sales of vehicles eligible for state support soared 49%, but many of these cars earn manufacturers as little as $100 each, according to researcher J.D. Power & Associates. Sales of bigger, more profitable vehicles were unchanged, so earnings for automakers are up less than 5%, J.D. Power says. "The tax cuts absolutely affected my choice," says Cui Tao, a 25-year-old resident of Tianjin who just bought a Geely Vision sedan for his fiancée. "I would have had to pay thousands more for a bigger car," he says.

TOYOTA'S DECLINE

The change has been hardest on the joint ventures of global automakers. They tend to concentrate on larger, more expensive cars, while Chinese manufacturers focus on smaller, cheaper models, putting them in a better position to gain from Beijing's stimulus measures. Shenzhen-based BYD Auto, for instance, has seen its sales soar 183%, to 208,000, in large part thanks to a hot-selling hatchback.

Compare BYD to Toyota Motor. The Japanese giant's China sales are up just 5% this year, despite the introduction of two new SUVs. That's a big change from last year, when Toyota's mainland sales jumped by 18.5%, to 570,000 vehicles. While the company doesn't disclose its China profits, Yuzo Ushiyama, who retired in June as Toyota's China chief, hints that the preference for smaller vehicles has hurt. "Relatively inexpensive cars are selling quite well, but in China that segment is not [where Toyota competes]," he said in a May interview. "We have to address the short-term decline in profitability."

Even global automakers with surging sales are having trouble getting any substantial profits. General Motors has sold 43% more cars in China this year than in 2008. But three-fifths of its mainland sales come from its Wuling unit, which mostly makes tiny commercial vans that cost as little as $4,300. GM doesn't reveal its China profits, but in the first quarter its Asian operation, of which China is by far the largest part, was in the red.

Sure, growing sales help offset shrinking margins. But the potential earnings from the world's new No. 1 market are far smaller than those in the pre-crisis U.S., where Toyota earned about half its global profits before the slump. Says Ashvin Chotai, managing director of consultant Intelligence Automotive Asia: "It will be very difficult for automakers to turn China into a cash cow like the Japanese did with North America." | BW |

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The Boom Beyond China

Vietnam's auto industry is also thriving as consumers cash in on tax breaks on smaller vehicles. Carmakers can't keep up with demand, writes online newspaper VietNamNet Bridge. An industry group says small sedans are the most popular models, and some analysts think 2009 figures could beat initial forecasts by up to 40%.

To read the story go to **bx.businessweek.com/asian-automakers/reference/**

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CASH FOR KITCHEN CLUNKERS

Home appliance makers need a lot of help—but a new federal rebate program may not generate much demand

By Matthew Boyle

A $296 million rebate plan to boost sales of energy-efficient home appliances may give companies such as Whirlpool and Electrolux a glimmer of hope, but it won't be enough to lift them out of their worst down cycle ever.

Beginning late this fall, the federal program will authorize rebates of roughly $50 to $200 for purchases of high-efficiency appliances that bear the Energy Star seal. The money is part of the broader economic stimulus bill passed earlier this year. Program details—such as which appliances are covered, the exact size of the rebates, and how they get processed—will vary according to each state's proposals, and the Energy Dept. has set a deadline of Oct. 15 for states to file formal applications to participate. Washington expects to award the bulk of the money by the end of November.

"IT'S BRUTAL"

Unlike the popular $2.9 billion cash-for-clunkers car program, which ended on Aug. 24, there's little evidence hard-hit consumers are clamoring to buy new dishwashers and fridges. (At least they won't have to trade in their old appliances.) The federal outlay piggybacks on rebate programs for energy-saving appliances that have existed for years in more than 25 states and largely failed to spur demand. Retailers such as Home Depot and Lowe's have offered deep discounts on big-ticket appliances lately, but with little impact. Shipments of washers, dryers, refrigerators, and ovens dropped 10% in 2008 and are down 15% through July, according to the Association of Home Appliance Manufacturers. "It's brutal," says Sam Darkatsh, an analyst at brokerage firm Raymond James.

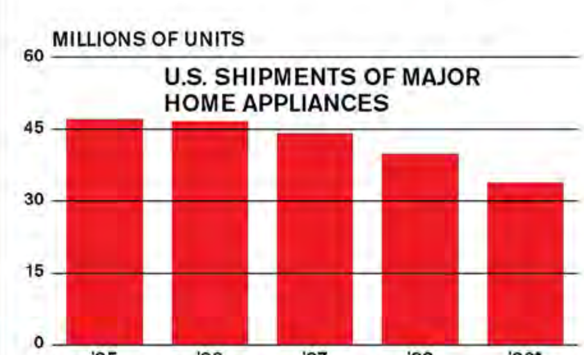


The leading appliance makers have been coping with tough times for a while. Although the housing boom lifted sales, high commodity prices and Chinese competition took a toll on margins. And now Whirlpool, of Benton Harbor, Mich., which controls nearly 50% of the U.S. market, has seen worldwide sales drop 20% through the first half of 2009, to $7.7 billion. In response, it will lay off 5,000 workers this year. Stockholm-based Electrolux, meanwhile, has axed 3,000 workers since December and shifted production to lower-cost countries. General Electric, which has been trying to sell off its appliance unit, mulled closing an entire Indiana plant earlier this year until deciding to keep it open with one-quarter fewer people.

Not surprisingly, appliance makers (and their investors) cheered the upcoming government handout. "Whatever gets the consumer back in the marketplace is good for us," says J.B. Hoyt, director of government relations at Whirlpool, where shares are up 40% since the program was disclosed on July 14. Still, Hoyt allows that "our business has a long way to go in terms of recovery." Electrolux Chief Executive Hans Straberg, meanwhile, told investors in July he doesn't expect the market to improve "in the near future." Electrolux says it is readying "aggressive" marketing programs that will amplify the rebates' appeal, but is waiting for state plans before providing specifics. Over the next month, appliance makers will lobby state energy commissions to provide the highest possible rebates. "Twenty-five dollars does not get consumers' attention on a $500 purchase," Hoyt says.

One challenge in assessing the potential impact of the incentive program is that consumers tend to purchase fridges and washing machines when an existing appliance breaks down or during a home renovation. An extra $200 isn't likely to spur thoughts of a costly renovation in a shaky economy, and most people coping with a broken machine would likely feel forced to replace it in any case. "I'm not sure if it will be as powerful as Cash for Clunkers," notes Laura Champine, a senior analyst with Cowen & Co. "But any driver [of sales] is welcome right now." |BW|

COOLING DOWN



*Full-year estimate
Data: Association of Home Appliance Manufacturers

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A RADICAL RETHINK OF R&D

THE FUTURE OF TECH

036 How Science Can Create Millions of Jobs
040 Big Blue's Global Laboratory
044 Microsoft Research Keeps Dreaming Big

By Steve Hamm

Once upon a time, the U.S. was the world's unrivaled innovation leader. America had the best universities, the strongest corporate research, and a government that invested aggressively in things like space exploration and advanced communications. The result was a steady stream of world-changing innovations, from the transistor at Bell Labs to the Internet at the Defense Dept.

The country's leadership is no longer unrivaled. While the U.S. still tops most global rankings for research investment and productivity, aggressive countries from Asia and Europe are closing the gap. This shift creates both a challenge to the U.S. and an opportunity for a new kind of innovation. The key is recognizing that the future of research will transcend national boundaries and corporate walls.

IBM has launched a major initiative to capitalize on the changes. It's forming tieups with governments, universities, and companies globally to harness new ideas and pursue promising avenues of research.

The role for government is evolving too. Countries such as the U.S. must foster innovation at home, even as their multinationals explore opportunities abroad like never before. The Obama Administration has promised to make science and technology top priorities, but the economic meltdown forced it to focus on the crises du jour. Thomas Kalil, deputy director of the Office of Science & Technology Policy, says the tens of billions in stimulus money allocated for science research, clean energy, and other projects is only a "down payment."

Research breakthroughs are especially important at a time of turmoil. They can lay the foundation for the industries and jobs of the future. But they won't happen without creativity from companies and government.

HOW TO PLAY IT 066



THE FUTURE OF TECH

NASA's Apollo project sped up advances in computing and telecom

HOW SCIENCE CAN CREATE MILLIONS OF NEW JOBS

By Adrian Slywotzky

Reigniting basic research can repair the broken U.S. business model and put Americans back to work

Name an industry that can produce 1 million new, high-paying jobs over the next three years. You can't, because there isn't one. And that's the problem.

America needs good jobs, soon. We need 6.7 million just to replace losses from the current recession, then an additional 10 million to keep up with population growth and to spark demand over the next decade. In the 1990s the U.S. economy created a net 22 million jobs, or 2.2 million a year. But from 2000 to the end of 2007, the rate plunged to 900,000 a year. The pipeline is dry because the U.S. business model is broken. Our growth engine has run out of a key fuel—basic research.

The U.S. infrastructure for scientific innovation has historically consisted of a loose public-private partnership. It included legendary institutions such as Bell Labs, RCA Labs, Xerox PARC, and the research operations of IBM, along with NASA, the Defense Advanced Research Projects Agency (DARPA), and others. In each of these organizations, programs with clear commercial potential were supported alongside pure research. There was ample corporate and venture capital funding for commercialization, so the labs were able to make enormous contributions to science, technology, and the economy—including the creation of millions of high-paying jobs.

Consider a few milestones from Bell Labs: Fax transmission, long-distance television transmission, photovoltaic solar cells, the transistor, the UNIX operating system, and cellular telephony. Each of these innovations laid the groundwork for vibrant new industries. The transistor alone is the building block for computers, consumer electronics, telecom systems, high-tech medical

FRITZ GORO/TIME LIFE PICTURES/GETTY IMAGES

devices, and much more. Likewise, DARPA's creation of the Internet (as ARPAnet) in 1969 and Xerox PARC's development of Ethernet and the graphical user interface (GUI) set the stage for the PC revolution. These basic research breakthroughs unleashed cycles of applied innovation that created entirely new sectors of our economy.

But since the 1990s, funding for basic research has slowly declined. Bell Labs had 30,000 employees as recently as 2001; today (under current owner Alcatel-Lucent) it has 1,000. That's symbolic and symptomatic of the broken link in the U.S. business model. With upstream invention and discovery drying up, innovations capable of generating an industry have thinned to a trickle.

It's tempting to ascribe current job losses in the U.S. to the deep recession or to outsourcing, but the root of the problem is the absence of high-value job creation. We have been through three recessions since 1981, not including the current economic meltdown. Throughout those years, U.S. companies have engaged in aggressive outsourcing, yet the economy bounced back from each downturn with a new blockbuster industry or two. Eventually we will emerge from the current recession, but don't expect to see the same kind of job-creating vigor this time around.

In the past, when the U.S. exported high-paying jobs to low-wage countries, we replaced them with even greater numbers of high-paying jobs in industries whose inception could be traced back to science done decades earlier. The PC, Internet, and cellular industries, born in the 1980s and 1990s, more than offset the loss of high-paying jobs in consumer electronics, steel, and other sectors. But in recent years, outsourced software and manufacturing jobs have largely been replaced by millions of low-wage service jobs in fast-food, retail, and the like.

Compounding the effects of outsourcing and extended recession, the ongoing destruction of old business models (think print journalism, the music business, and landline telephones) will slash a large number of high-value jobs in the coming decade. The result? A broken demand structure. Of the roughly 130 million jobs in the U.S., only 20%, or 26 million, pay more than $60,000 a year. The other 80% pay an average of $33,000. That ratio is not a good foundation for a strong middle class and a prosperous society. It's time to identify—and fix—the root of the problem.

The good news is that restarting the science engine is quite doable and doesn't require massive investment relative to other spending. Venture capitalists are sitting on plenty of cash and are good at bringing startups to the market. We just have to rebuild the upstream labs that focus on basic research—the headwaters for the whole innovation ecosystem.

TOLERANCE FOR RISK—AND FAILURE

The difficulty is that science is a crapshoot. It depends on the efforts of hundreds of people with high IQs, PhDs, deep curiosity, and a strong work ethic—not to mention serendipity. It also takes a certain critical mass, not just in people, but also in infrastructure, which means lab support, equipment, and instrumentation. It takes open communication among peers and other subtle but critical cultural factors. Success requires a tolerance for risk—and failure; a willingness to think and apply innovation laterally (many of the big breakthroughs were originally aimed at other targets); and a culture that attracts and rewards the best minds.

The innovation path itself is unpredictable. Who in 1975 could have seen how the PC would evolve, how it would engender networking giants such as Cisco, or how that shift would lead to an online revolution and blockbuster businesses such as Amazon, eBay, and Google? Who in 1980 could envision that the work at Bell Labs in novel cellular communications technology would lead to the global mobile revolution?

Many of the classic scientific research labs, such as Bell and RCA, were funded by companies with virtual monopolies and strong, predictable cash flow. But such companies hardly exist today. With the increasing focus on shareholder value that started in the 1990s, top companies could no longer justify open-ended research that might not have a near-term impact on their bottom lines.



The mouse that roared: Invented by DARPA and improved at Xerox PARC, this device made point-and-click computing possible

COURTESY OF THE COMPUTER HISTORY MUSEUM

Of all the recent developments, the diminution of Bell Labs may be the most jarring. Founded in 1925 to devise new equipment for the Bell System phone companies, its scientists amassed no fewer than six Nobel prizes. However, starting in 2001, budget cuts forced drastic reductions in laboratory funding and staffing. In 2008 parent Alcatel-Lucent pulled the plug on the last remaining areas of basic science—material physics and semiconductor research—to focus on projects with quicker payoffs.

A similar fate befell RCA Labs. In the 1950s and '60s it produced breakthroughs in color TV, tape recording, transistors, lasers, solar cells, and infrared imaging. At its peak in the 1970s, RCA was generating more patents than rival Bell Labs. By the time GE purchased RCA in 1986, the Labs had already started their long-term decline.

Xerox's Palo Alto Research Center (PARC) and DARPA also played transforming roles. PARC, for example, improved on DARPA's invention of the computer mouse and made point-and-click computing possible. It also incubated Ethernet technology, laser printing, and other ideas that sustained dozens of major Silicon Valley companies. DARPA,

set up in 1958 as a response to the Soviet launch of Sputnik, is responsible for the Internet and numerous technologies with applications beyond the military. Its breakthroughs range from computer graphics, microprocessors, and advanced semiconductor design to parallel computing and local-area networks, and among its direct technological progeny are dozens of major companies—especially those that thrive on the Net. The agency continues to seed new research in the area of renewable power and energy efficiency, but its mission has largely shifted from science to tactical projects with short-term military applications.

For any institution, cutting back on basic research may make great sense in the short term. For a time you can free-ride off the investments of others. But then you have the "tragedy of the commons" writ large. What's good for the company ("cut the science") is a disaster for the system—no new industries.

While the timeline for translating scientific research efforts into tangible results is typically 15 years or longer, that cycle can be accelerated. We've done it at least twice: The Manhattan Project created the atomic bomb in six years; the Apollo Program landed a man on the moon just eight years after President John F. Kennedy set his famous goal for our space effort. Apollo not only had a big short-term impact on jobs, but also sped up development of key computer and communications technology and unleashed a host of innovations in fuel cells, water purification, freeze-drying of food, and digital image processing used in CAT scans and MRIs.

Today's challenges in the areas of energy, health care, transportation, water supply, climate change, and more will require Washington to unleash a series of focused projects, supported by research investments in a dozen or more leading companies. Only such direction and support could reproduce, on some scale, the cumulative impact of Bell Labs, RCA Labs, Xerox PARC, and the rest. In essence, the U.S. must recreate a broad network of industrial and national labs, perhaps catalyzing the process with one or two major national initiatives.

BREAKTHROUGHS

Research milestones over 80 years at Bell Labs helped create entire industries. A few highlights:

1925
First public demonstration of fax transmission

1927
First long-distance TV transmission

1947
Invention of the transistor

1954
Invention of photovoltaic solar cell

1969
Creation of the UNIX operating system

1978
Development of the first large-scale cellular-phone system

Data: Bell Labs

It won't be easy to replace Bell Labs' scale of 30,000 workers or instill the urgency of a Manhattan Project. Given that the U.S. economy is so much bigger than it was 40 years ago and so much less competitive internationally, several equivalent corporate research labs may be needed. But there is no shortage of plausible participants—top research corporations such as IBM, Hewlett-Packard, Cisco, Google, ExxonMobil, DuPont, and Microsoft. These companies already employ hundreds of PhD researchers and scientists, and while their labs mostly focus on shorter-term development goals, they still retain the spirit of scientific pursuit.

Funding is always an issue, but consider that Bell Labs' budget peaked at $1.6 billion in 1982—about $3.6 billion in 2009 dollars. Today, $20 billion a year could fund three large labs and five smaller ones. Split between public and private sources, $20 billion is not so much. If leading companies committed a small percentage of their R&D budgets to pure research in exchange for a tax credit or a government match, a new innovation ecosystem would quickly begin to take shape. It would also be much easier to attract top minds today than during the dot-com boom of the 1990s or the financial innovation boom of this decade.

The choice facing the country is to do nothing and risk the decline of innovation or act boldly by reasserting our faith in scientific inquiry and discovery. We can't do this as a series of half steps that are expensive but ineffectual, that don't reach critical mass or a critical rate of change. This middle-road approach might well describe NASA over the past 30 years—not necessarily a good model.

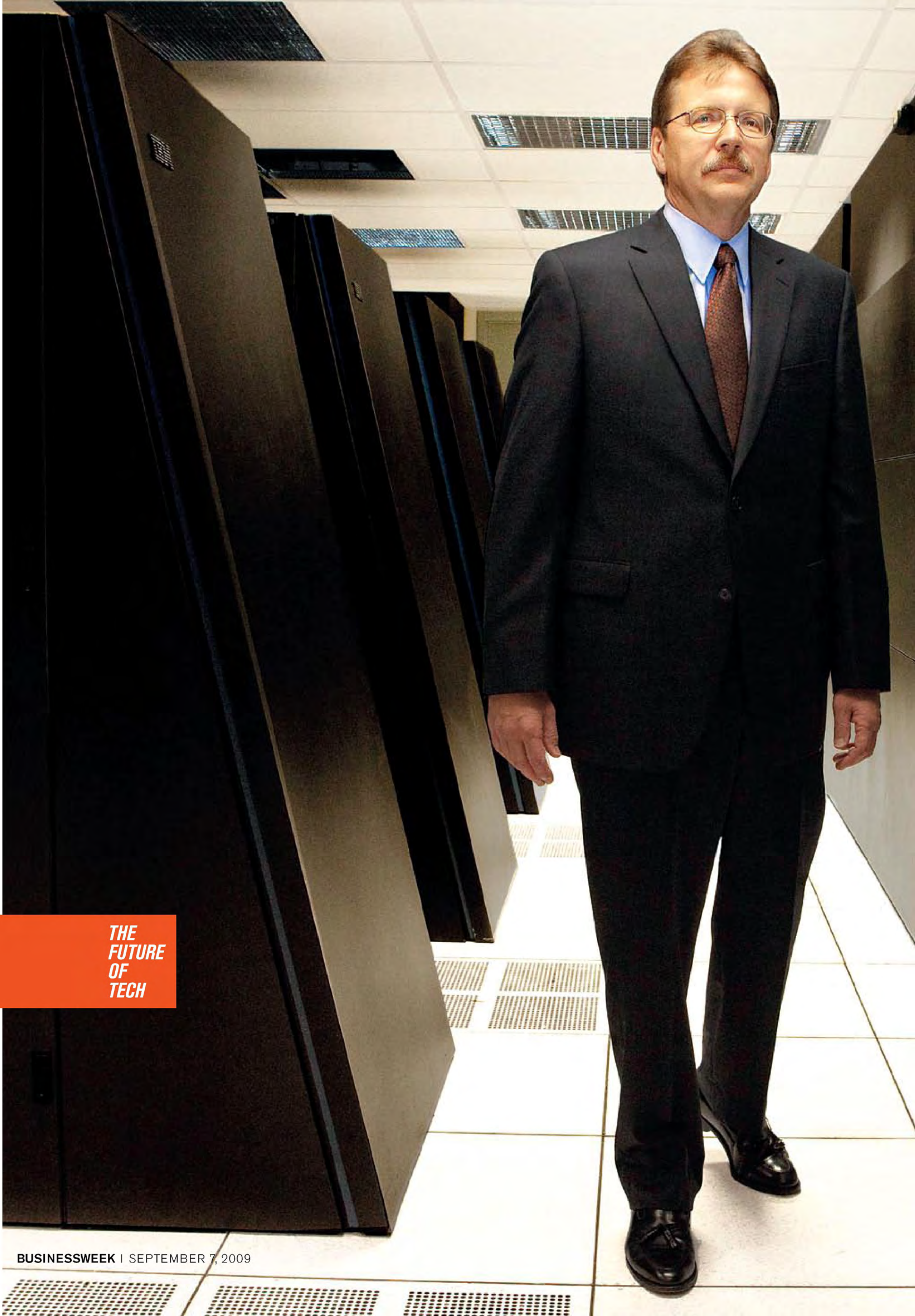
The better model is the one we have put aside: a dynamic public-private ecosystem of large-scale labs and a venture capital industry waiting downstream to commercialize ideas and turn them into large public companies that create lucrative and satisfying jobs. What's needed to get that model back on track? First, clear national goals in two or three key areas, such as carbon-free energy and preventive medicine. Second, a commitment of $10 billion a year, above and beyond spending for national agencies, to jump-start new industrial research labs. Third, government tax credits for corporations that promise to spend, say, 5% to 10% of R&D on basic research.

In 1943, Elmer W. Engstrom was put in charge of RCA Labs in Princeton, N.J. After the war, as he reflected on the task before him, he called attention to "the depletion of basic knowledge" that resulted from shifting resources from basic science to war-related applications. He said universities were great institutions, but "you couldn't count on them alone" to close that knowledge gap.

Engstrom believed that it was a duty of the great industrial labs to "rebuild the war-depleted inventory of basic scientific knowledge." He also believed that "by doing work in fundamental research of a quality which will command the respect of scientific investigators in universities, we will stimulate work there which will, in effect, enlarge the scope of the work done within RCA Laboratories and thus bring about more rapid progress."

Although the causes of our concerns are different, Engstrom could be providing a precise description and prescription for our situation today. He could be calling out from the 1940s to our leaders today, articulating a challenge and a solution. If only a dozen major companies respond to that challenge, they can, in collaboration with the government, solve our jobs problem within a decade. |BW|

Slywotzky, a partner at management consultants Oliver Wyman, has written several books on profitability and growth.



THE FUTURE OF TECH

BIG BLUE'S GLOBAL LAB

In an historic break, IBM is making radical collaboration with outside partners an essential part of its research strategy

By Steve Hamm

Photograph by Len Irish

When Brazilian President Luiz Inácio Lula da Silva met with IBM Chief Executive Samuel J. Palmisano in Brasilia on Aug. 5, the former firebrand labor leader and the captain of industry had plenty to talk about. Brazil is planning to invest $22 billion in science and technology innovation in 2010, and it's pressing companies to contribute billions more to the effort. IBM, meanwhile, is prowling the world to set up what it calls "collaboratories," which match up its researchers with experts from governments, universities, and companies. As the two leaders discussed their ambitions, the meeting stretched from its scheduled 30 minutes to nearly an hour. "I hope to see you many more times," da Silva told Palmisano in the end, with a twinkle in his eye, "because it would mean you're announcing many investments in my country."

Any deal between IBM and Brazil is months away, but the company's new research approach is taking off now. IBM is trying to convince countries and companies that it can help them improve their ability to innovate at an important moment for the global economy. "Investments in innovation are critical, especially in a downturn," says Palmisano. "They can help Brazil and other countries, including the U.S., realize an economic expansion."

IBM has hammered out six deals for collaboratories in short order—in Saudi Arabia, Switzerland, China, Ireland, Taiwan, and India. Four more are in the works. John E. Kelly III, director of IBM Research, says there's enough demand for 100 more tieups. "The world is our lab now," says Kelly. "I figure I can have a much larger impact on the company and our research if I operate this way."



IBM Research's Kelly says "the world is our lab now"

The strategy marks a sharp break with how corporations have historically conducted basic research. For decades companies such as IBM, AT&T, and Xerox treated the work done in their labs as top secret. Research facilities were fortress-like, with special passes for the most sensitive areas. In recent years, companies such as Hewlett-Packard and Intel have begun tapping talent from outside for essential bits of science and technology—a concept called open innovation. Now IBM is moving a giant step further by making collaboration with outsiders an essential piece of its research strategy. The depth of that collaboration, the number of partners, the staff involved, and its global reach set IBM apart. "To move in this direction you have to be willing to not just take risks but be open to accepting ideas from around the world," says Soumitra Dutta, professor of business and technology at Europe's INSEAD.

There's no guarantee IBM can make this approach work on a grand scale. Many of the more limited joint projects have run into problems as companies tussled over expenses and intellectual property rights. But if the approach succeeds for IBM, other companies may follow its lead. "This is a great way to diversify your research portfolio, leverage what you have already, and get new knowledge and inventions," says Karim R. Lakhani, an assistant professor at the Harvard Business School.

Such collaborations are controversial, though. What's good for IBM and its corporate brethren isn't necessarily good for America. Critics say U.S. competitiveness is weakened when flagship corporations do crucial research projects overseas. "I'm alarmed," says Clyde V. Prestowitz Jr., president of the think tank Economic Strategy Institute. He says it's sensible for American multinationals to seek these tieups but urges the U.S. government to intercede and offer incentives to keep the most important research here. "We need a change in mentality. The attitude of Washington has been aggressively hands-off," he says.

STRETCHING DOLLARS

The U.S. may have to act quickly to forestall a rising tide of offshore research. After aggressively moving manufacturing and software programming to other countries, American corporations are setting up research labs overseas as well. But building brick-and-mortar labs and hiring large staffs is expensive, so some, like IBM, are beginning to establish closer relationships with foreign governments and universities. For instance, computer maker Hewlett-Packard formed a joint lab with Tsinghua University in Beijing. Chip giant Intel has set up joint research centers in China and Germany. "We'll have more and more global research," says Andrew A. Chien, vice-president for future technologies research at Intel. "We have an imperative to reach out and tap that power."

The attraction for IBM is clear. The collaborative strategy snags more research with roughly the same amount of IBM money. Performing research with a variety of partners in many locations also exposes IBM to science challenges and ideas that it might not otherwise encounter.

For years, IBM's crown jewel has been its 3,000-scientist research department—with labs in New York, California, Texas, Massachusetts, China, India, Israel, Japan, and Switzerland. Although revenues have declined by double digits this year, the budget for research is holding steady. The payoff: Thanks in large part to the labs, IBM has remained on the

OPENING UP

Companies are experimenting with collaborative research.

HEWLETT-PACKARD

Through its Innovation Research Program, the computer giant holds annual competitions to select academic projects related to its top priorities. Professors work with HP scientists.

PROCTER & GAMBLE

The company solicits solutions to science or product development challenges. It also accepts unsolicited ideas covering everything from packaging to research methods.

ELI LILLY

Lilly has formed several co-development deals with Indian companies, including one with conglomerate Jubilant to speed up the process of determining whether newly discovered molecules can be turned into drugs.



Saudi Arabia's KAUST is "a magnet for smart people," says CIO Al-Ghaslan

cutting edge of supercomputing, chip manufacturing, and datacenter management.

With the collaboratories, IBM hopes to make research an even bigger contributor. Each joint venture is expected to be staffed with 10 to 100 scientists targeting technologies that can deliver results in a relatively short time. The strategy is synchronized with what IBM calls its "Smarter Planet" push, where it offers technologies and services to improve transportation, electrical grids, and other systems.

IBM and other companies pursuing similar strategies face complex hurdles, however. It's not easy to set up and run this kind of lab. First, IBM has to sift through hundreds of potential partnerships to pick the ones that make the best fit. Then the company and its partners have to negotiate contracts that spell out responsibilities and protect each side's interests. One major potential hangup is dealing with intellectual-property ownership. In a typical collaborative research agreement, IBM wants to co-own the intellectual property or have exclusive rights to it, but that's not always acceptable to universities. One potential IBM project in Eastern Europe fell apart last year because the university wanted to control both the intellectual property and research agenda. "That was a showstopper," says Kelly.

THE FUTURE OF TECH



The man behind IBM's new research strategy is a tall, sandy-haired 55-year-old with R&D in his DNA. His father worked as a technician at General Electric's lab in Niskayuna, N.Y., and Kelly would visit regularly as a boy, watching his father work with vacuum tubes and other technologies. Kelly got a PhD in materials engineering at Rensselaer Polytechnic Institute. At IBM, he ran one major research department, in between stints in the chip division.

IBM's collaboratory strategy emerged from Kelly's management of the chip unit during a challenging time. Going it alone in chip manufacturing had become prohibitively expensive, so, starting six years ago, Kelly forged joint development deals with eight corporations, both U.S. and foreign, and helped New York State establish a nanotechnology research facility.

When Palmisano handed Kelly the research job two years ago, he urged him to help further IBM's ambitious global expansion plans. Within weeks, the collaboratory concept was born. "I became convinced you can do real radical collaboration if all the stars align," Kelly says.

GRAND AIMS

By radical, he means a large number of large-scale ventures. While most corporate arrangements with university researchers call for the funding to come from the corporation, IBM aims for a minimum of 50% funding by its partners. Also, the goals must be grand—focusing on areas of research IBM considers crucial to its future. For example, IBM is building and jointly operating a new $70 million semiconductor lab for nanotechnology research with ETH Zurich, a state-funded university in Switzerland. IBM hopes the research will help produce the next semiconductor switch—replacing technologies that have held sway for nearly half a century. By participating in this kind of research, countries have the potential to build new industries, and universities can attract the best faculty and students.

Kelly struck his first partnership with the King Abdullah University of Science and Technology in Saudi Arabia. The school, scheduled to open on Sept. 23, is the country's attempt to create a world-class research university from scratch. It's hiring top scholars from all over the world. "Our goal is to kick-

Business Exchange

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Open Innovation Origins

Henry Chesbrough wrote a pioneering book on the concept of "open innovation" in 2003. He examined early experiments at Intel and other companies and argued that the traditional model of doing research in-house is giving way to an approach that integrates more ideas from the outside.

For an overview of the book and Chesbrough's latest work as executive director at the Center for Open Innovation, go to **bx.businessweek.com/business-innovation/reference/**

BEN BAKER/REDUX PICTURES

start an innovation-based economy," says Ahmad O. Al-Khowaiter, the university's vice-president for economic development. "We need a couple of success stories, and we think this will lead to one."

KAUST agreed to buy an IBM supercomputer, which is an essential tool in the research projects that IBM and the Saudis are targeting. Among other things, the two teams will collaborate on a study of the nearby Red Sea, which they believe will help improve oil and mineral exploration. "[The computer] is a magnet for smart people, and it makes it possible for us to solve big problems," says Majid F. Al-Ghaslan, KAUST's interim chief information officer.



THE FUTURE OF TECH

(TOP) DAVID HOGSHOLT/GETTY IMAGES

Now, dozens of deals are in the offing around the world. IBM uses a complex algorithm to identify the most promising situations. The factors considered include everything from available talent to government stability and corruption.

Kelly got an update on the latest possibilities during a daylong meeting of lab directors and department heads on July 15. About 30 people gathered in a conference room and listened to Colin Parris, head of the collaboratories development team, present the update. He showed a map of the globe with dots all over it—except for sub-Saharan Africa and South America. Kelly sat near the front of the room with his legs crossed and his chin resting on his hand. "Look, guys. South America. Nothing yet," he said, gesturing at the map. "You've got to get started."

There's certainly plenty of action elsewhere. A dozen potential deals are under discussion in China alone, and one partner-

MICROSOFT RESEARCH KEEPS DREAMING BIG

Thinkers are free to let their minds wander as they look to the future

By Helen Walters

Rick Rashid, head of Microsoft's research arm, oversees 850 of the brainiest people in the technology industry. But he doesn't push them to help the Microsoft groups working on the next Windows operating system or upcoming Xbox. Instead, he gives researchers wide leeway to pursue their own interests and write papers about ideas that may not pay off for 10 or 20 years—if at all. "We're about doing things that frankly people may not want," says the 57-year-old Rashid, tilting back in the desk chair in his modest office on Microsoft's Redmond (Wash.) campus. "The point of a basic research group is really to do the things you don't know you'll need."

It's an increasingly rare—and some say outdated—approach to corporate research. In recent years, as cost-cutting pressures have mounted, tech giants from Hewlett-Packard to IBM have pushed their researchers to concentrate on practical ideas, projects that are likely to lead to a financial payoff. But Microsoft has maintained the same hands-off, academic approach to research it has had ever since Rashid was recruited from Carnegie Mellon University in 1991 to lead the effort. "Research management is almost an oxymoron," he says.

Microsoft is coming under growing financial pressure. In July, the company reported its first annual decline in revenues since going public in 1986, and it had substantial layoffs earlier this year for the first time ever. But Craig Mundie, Microsoft's chief research and strategy officer and Rashid's boss, says there's no plan to change course. "Even now, I worked to preserve full investment in Microsoft Research," he says. "This is a lifeblood issue for the company, and



Niu Gang is looking to IBM to transform China Telecom technology

ship is already off the ground. IBM began working last October with China Telecom, the government-controlled communications giant, to apply its data analysis technologies to China Telecom's huge database of subscriber and service information. As a test project, China Telecom wanted to be able to understand customer desires so it could craft improved packages of mobile, landline, and broadband services. Using IBM algorithms, researchers are chomping through billions of service records looking for patterns.

Niu Gang, deputy director of China Telecom Technology Research Institute in Shanghai, says the challenges his company faces are similar to those IBM confronted in the 1980s. "[IBM] successfully transformed itself," he says. "We hope technology innovation will help transform us into a brand new company."

For IBM, the alliance offers a pathway into an important market. China Telecom's service data gives IBM scientists a rare opportunity to try out technologies on massive amounts of real-life data and fashion algorithms optimized for the telecom industry. IBM is already using some findings as it works with other telecoms.

IBM looks for a large payoff from each collaboratory. In the case of the Zurich project, the company did not want to bear the expense of building a new clean room for advanced chip research on its own. A mutual friend of Matthias Kaiserswerth, head of IBM's Zurich lab, and Peter Chen, chief of research at ETH, had learned they were both interested in building new facilities. He introduced them at a gathering at the tony Grand Hotel Quellenhof in Bad Ragaz, Switzerland, in 2007. The two hit it off immediately. "I had never done anything like this before," says Kaiserswerth. "It comes down to whether you trust people and have congruent interests."

Researchers at IBM and professors at the university conducted a series of meetings where they hashed out priorities. They found a 70% overlap—plenty to make an alliance worthwhile. For instance, they targeted an area of physics called spintronics that could lead to the new generation of chips.

Often, IBM gets projects started by dispatching a single scientist with a big idea. Henry Chang, a 22-year veteran of IBM's labs, returned to his native Taiwan last year and helped a professor at National Taiwan University write a proposal for how the country could shift from an electronics manufacturing economy to one with more high-value tech services. The model he used: IBM's own transformation from a computer company to a services and software giant. "The government liked the idea. They wanted to have a conversation about making the transition," says Chang. On Aug. 12, IBM signed a deal with Taiwan's government to improve the national health-care system.

Such projects could fuel concerns about American competitiveness, but two-thirds of IBM's scientists work in the U.S. and there will be collaboratories here, too. IBM is working with Virginia Tech and Arlington County, Va., to develop a lab focused on advanced systems for crisis management.

IBM still faces plenty of challenges in getting its collaboratory strategy to work. But Palmisano put Kelly on notice in a one-on-one meeting in July that he wants him to think even bigger. Kelly isn't exactly sure what that will mean, but he's mulling it over. "The biggest challenge is to not overextend ourselves," he says. "I want to be very aggressive, but I don't want to trip up." | BW |

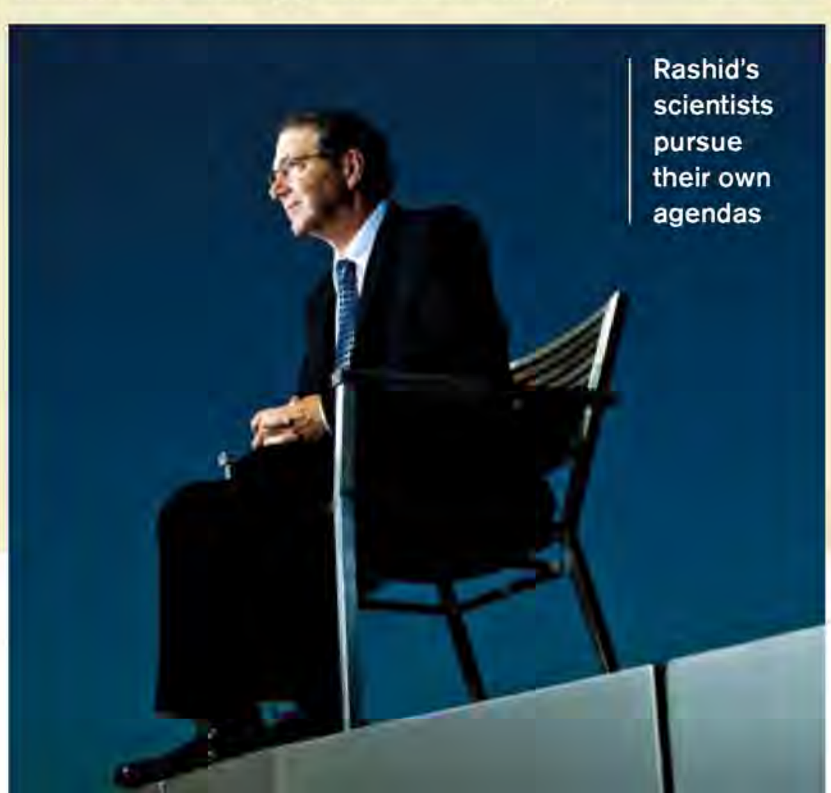
there's no intent to change the model."

Outsiders on Wall Street and in Silicon Valley gripe that Microsoft has little to show for its patience, but Rashid says Microsoft Research (MSR) has made important contributions to new products. Natal, a gaming system launched in June, is based on work from the research unit's Cambridge, England, lab. Bing, Microsoft's search engine, includes innovations from MSR. Another research team, led by Lili Cheng, is integrating social networking into the corporate world. Some of her ideas will be built into an upcoming version of the Outlook e-mail program, making it easier to organize messages from certain friends or work groups.

Rashid won't identify which areas of research he thinks are most promising since he wants his staff to find their own way. But his team is delving into potential breakthroughs in robotics, health care, security, and privacy. Cynthia Dwork, principal researcher in MSR's Silicon Valley lab, is working with people inside and outside the company to set standards for privacy and lay the foundation for products Microsoft could later sell to help people manage their privacy online.

Experts say MSR has yet to deliver the far-reaching innovations that could validate Rashid's approach. John Seely Brown, former director of Xerox's Palo Alto Research Center (PARC), says the transfer of technology from lab to marketplace is always challenging. "My sense is that MSR continues to be extremely inventive," he says. "But can they hand these insights, prototypes, services, to another beast that can do something with them? That's the classic dilemma."

Rashid says he doesn't want to become overly practical or short-term. He plans to keep recruiting the smartest people he can find and giving them plenty of freedom. "Our business is not a very forgiving business," he says. "I see my job as trying to ensure that 10 years from now there still will be a Microsoft."



Rashid's scientists pursue their own agendas

(BOTTOM) STEPHEN VOSS

THE MOST POWERFUL BANKER YOU'VE NEVER HEARD OF

By Mara Der Hovanesian • Illustration by Jason Holley

Lewis Kaden is the ultimate behind-the-scenes power player. Lobbying the White House for Citi may be his biggest role yet

Lewis B. Kaden doesn't stand out among the high-powered executives on Citigroup's organizational chart. He's one of three people who carry the title of vice-chairman, and he doesn't run a big revenue-generating business such as investment or retail banking. Kaden's official duties are largely administrative—human resources, government affairs, and philanthropy among them. ¶ Behind the scenes, however, the 67-year-old Kaden has emerged as the most influential adviser to Citi CEO Vikram Pandit and a key conduit to the Obama Administration. "He's the most powerful man in financial services you've never heard of," says a former executive who worked with Kaden under Pandit and Citi's previous CEO, Charles O. Prince III. Kaden's clout "extends significantly throughout the organization. Some say he's the CEO with a lowercase c-e-o."

Kaden's fingerprints have been all over the bank's maneuverings during the financial crisis. When Prince left the bank in 2007, Kaden advised the team that picked Pandit for the top job. He co-chairs the group that oversees how the bank uses $45 billion in federal bailout money and negotiates with regulators on hot-button issues such as compensation. He's also trying to spiff up Citi's image, seeking out a high-powered consulting firm to develop a new public-relations strategy for the bank. Most important, he's a sounding board for Pandit at a time when sage advice has never been more crucial.

But Kaden, a corporate attorney for decades before joining Citi in 2005, hasn't always shown himself to be a brilliant banker. Serving on three of the firm's most important strategic committees—management, business heads, and business practices—Kaden stood by during the credit boom as Citi placed ever-bigger bets on subprime assets. "I thought bringing him in was a good idea," says a former member of Citi's executive management committee. "But he was in the same meetings I was [when] decisions were made to take on more risk and load up the balance sheet. If nothing else, he didn't step up and say: 'This is all insane. Why are we doing this stuff?' " Kaden also brokered the $800 million acquisition of the hedge fund that brought Pandit to Citi but was shuttered soon after for poor performance. And he paved the way for the pricey deal to name the New York Mets' new stadium Citi Field, drawing sharp criticism from many quarters.

That Kaden has been able to survive Citi's tumult—and his own apparent missteps—speaks to the peculiar niche he has come to occupy in the New York business and political Establishment. Part Karl Rove, part Zelig, Kaden has quietly shaped the decisions of a broad array of powerful leaders in business and government—but without bearing ultimate responsibility for those deci-



KADEN'S POLITICAL CONNECTIONS INCLUDE CLOSE TIES TO KEY OBAMA OFFICIALS, AMONG THEM LARRY SUMMERS, A FRIEND FOR OVER 20 YEARS

sions. Says Zöe Baird, president of the Markle Foundation, a health-care and national security think tank where Kaden is chairman: "He's not the kind of person who tries to impose his views, but [rather] helps think through problems."

Over the years, Kaden has advised corporate chieftains, including Ford Motor's Bill Ford and General Electric's Jack Welch (now a *BusinessWeek* columnist). He has also counseled politicians such as ex-governors Mario Cuomo of New York and Brendan Byrne of New Jersey. His political travels have brought abiding friendships with key Obama Administration officials, including chief economic adviser Lawrence H. Summers. For all his lofty credentials, Kaden's personal connections may turn out to be his most valuable asset as he helps dislodge Citi from the teeth of the financial crisis.

HUMBLE ORIGINS

Lewis Kaden is an unlikely Wall Street power broker. The son of a trucker in Perth Amboy, N.J., he excelled at the local public high school, earning a scholarship to Harvard. After graduating magna cum laude in 1963 with degrees in history and mathematics, he attended Harvard Law School, studying constitutional and labor law and winning a coveted position as an editor of the *Harvard Law Review*. Even in his 20s the soft-spoken Kaden projected power. He had "a presence, a maturity, and a confidence in himself that was modest and not arrogant," says Richard B. Stone, a classmate at Harvard who teaches at Columbia University School of Law.

With law degree in hand, Kaden spent the next few years weaving in and out of politics. He clerked for the Second Circuit Court of Appeals in between stints working for New York Senator Robert F. Kennedy, first as a legislative aide and then on Kennedy's Presidential campaign. After Kennedy's assassination in June 1968, Kaden took a job as an associate at the law firm of Battle, Fowler, Stokes & Kheel.

In 1970 Kaden did something uncharacteristic for a behind-the-scenes operator: He threw his own hat into the political ring. Kaden ran in the Democratic primary for a New Jersey congressional seat, but lost. "That was the wrong place for him," says Stone. "He was not a public candidate. He was someone who should be a Cabinet member and an intimate of a powerful elected person—the judgment behind the throne."

Kaden was already beginning to play that role back at the law firm. He impressed partner Theodore W. Kheel, a distinguished mediator and among New York City's most influential public advocates. When Kheel was asked in 1973 to travel to Paris to help the U.S. secure a peace agreement with the North Vietnamese, Kaden accompanied him. Among other highlights, Kaden was part of the infamous two-week negotiation over the shape of the conference table.

Despite having made partner at Battle Fowler, Kaden couldn't resist the lure of public service. In 1974 he signed on as chief counsel to New Jersey Governor Brendan T. Byrne. For most of the next two decades, Kaden would move freely between the private and public sectors. In 1976 he took a teaching job at Columbia University School of Law. It was there that he met his future wife, Ellen Oren, a fellow instructor who later was depicted in the film *The Insider* for her work as an attorney at CBS News during the flap over *60 Minutes*' controversial exposé of the tobacco industry. (She is now general counsel at Campbell Soup.) Kaden augmented his teaching job with government work, including a five-year stint at New Jersey's Commission of Investigation.



By the early 1980s, Kaden's extracurricular activities were beginning to overwhelm his ability to teach full-time. In 1984 he joined the New York law firm of Davis Polk & Wardwell as partner and began to burnish a reputation as an ethicist. In 1986 he moderated a panel for PBS's *Ethics in America* series, which won a Peabody Award. Soon top business leaders were seeking his advice. GE's Jack Welch called on Kaden for his public policy expertise in negotiations with labor unions such as the AFL-CIO. New York Mets owner Fred Wilpon and seven other owners relied on Kaden for advice during the 1994-95 players strike; Kaden later represented Wilpon in the acrimonious buyout of the team from his former partner, Nelson Doubleday Jr. All the while, Kaden continued to dabble in public service, sitting on Cuomo's economic advisory panel in

ADVISER FOR HIRE | Even before Citi, Kaden was counseling top executives

GENERAL ELECTRIC
In discussions that started in 1998, GE's then-CEO Jack Welch and union officials tapped Kaden for his public policy experience

NEW YORK METS
The owner, Fred Wilpon, hired Kaden to counsel him during the 1994-95 players' strike and then again during an acrimonious buyout of his former partner

BETHLEHEM STEEL
Kaden, a board member, helped hire the steelmaker's last CEO, Robert Miller, and approved the company's controversial sale

J.P. MORGAN
He helped the bank persuade the government to grant it the right to underwrite securities, the first step in eliminating Depression-era Glass-Steagall regs

Data: *BusinessWeek*



ANTHONY DELMUNDO/NEW YORK DAILY NEWS

Kaden (circled), Wilpon (second from right), and New York Mayor Michael Bloomberg (center) at the groundbreaking for Citi Field

the late 1980s and editing the governor's 1992 book *America's Agenda: Rebuilding Economic Strength*.

One important connection Kaden made along the way was with Goldman Sachs executive and future U.S. Treasury Secretary Robert E. Rubin. The two worked for Walter Mondale's Presidential campaign in 1984, reunited in 1987 on Cuomo's economics panel, and for 25 years have shared a passion for Democratic politics and public service.

In 2005, Rubin, then chairman at Citigroup, persuaded Kaden to leave Davis Polk and take a job as chief administrative officer at Citi—playing much the same role for Chuck Prince that Prince had played for the previous CEO, Sanford I. Weill. Citi needed an ethics czar who could help clean up the bank's sullied reputation. Japanese officials had just kicked the company's private bank out of the country for lax money-laundering controls, the British Financial Services Authority had launched a probe into Citi's London trading operation, and the bank was still dealing with the taint of the Wall Street research scandal earlier in the decade.

Almost immediately, Kaden stepped into the role of public-relations master. He joined with Prince on a global campaign to sell Citi's new corporate responsibility plan to investors, shareholders, and regulators. "At Citi we pay attention to corporate governance to limit risk and exposure," Kaden said in a speech delivered at Boston University in November 2006. "We want our employees to identify Citi as both a good employer and a respectable institution."

Kaden got a taste of dealmaking as well. When Michael Carpenter, head of the bank's alternative-investments business, left the firm in March 2006, Prince named Kaden interim chief. In that role, Kaden brokered the $800 million acquisition of Old Lane Partners, the hedge fund that Pandit had started after leaving Morgan Stanley in 2006. Pandit pocketed $80 million from the sale and became a Citi employee. But the acquisition quickly soured; in June 2008, Citi shuttered the ailing hedge fund, and the bank took a $202 million writedown.

Old Lane isn't the only questionable deal Kaden helped engineer. In 2006 he tapped his connections with Wilpon to win for Citi the naming and sponsorship rights to the club's new stadium—a deal that delivers $400 million to the Mets over 20 years. When Citi Field opened in April, the bank, a major recipient of bailout money, came under fire. "It's just totally unacceptable that Citigroup should be able to spend $400 million in naming rights when they're the recipients of a massive federal bailout," Representative Dennis Kucinich (D-Ohio) said at the time. The congressman, along with Representative Ted Poe (R-Tex.), sent a letter to Treasury Secretary Timothy F. Geithner requesting the government "dissolve the

agreement," but Treasury chose not to do so.

Despite Kaden's close association with Prince, he sidestepped the shakeup of Citi's management in 2007. When Prince left in November of that year, Kaden kept his job, much to his own surprise. In fact, the board relied on his advice as it sought a new chief executive. A four-person team, headed by Richard D. Parsons, then a Citi board member and now chairman, took just a month to pick Pandit.

"CONSTANT THREAD"

For better or worse, Kaden has transitioned seamlessly into the new regime, maintaining his role as chief counselor to the CEO. "Kaden is very much the constant thread through the downfall of what used to be a pretty good institution," says one senior manager who worked with Kaden at Citi in 2005. A former Citi board member sees it differently: "[Kaden is] an invaluable source of judgment and clear-minded thinking for Pandit."

These days Kaden remains a tireless PR campaigner. After *The New York Times* published an article slamming Rubin in late 2008, Kaden wrote a letter to the editor, saying the story "painted a misleading and inaccurate picture of Mr. Rubin's role." In recent months, Kaden has interviewed consulting firms as part of an effort to reshape Citi's media and communications strategy. The plan, still in the early stages, is focused on developing more favorable press coverage and improving the firm's reputation with customers and investors.

Talent management is another of Kaden's main focuses—and sources of frustration. As head of human resources, he has been instrumental in overhauling Citi's management over the past 18 months. But some of Kaden's recommendations have sparked controversy. In January 2008, Citi hired Edward J. Kelly III, the former general counsel of JPMorgan Chase and a Davis Polk alumnus, to run strategy for the bank. When Chief Financial Officer Gary L. Crittenden stepped down in July, Kelly jumped into the role at the behest of Pandit and Kaden. But Kelly quickly started butting heads with Sheila C. Bair, chairman of the Federal Deposit Insurance Corp. Kelly reportedly referred to the FDIC as a second-rate agency, while Bair questioned his qualifications. In the aftermath of the scuffle, Kelly was shifted back to his original position. An FDIC staffer says the regulator didn't dictate Kelly's job change but adds that the move didn't go far enough in fixing Citi's weak management team.

Kaden's most important assignment may be his front-line role in discussions with the government, Citi's biggest shareholder. He is part of a group of top executives who regularly meet with U.S. officials and regulators on everything from compensation to management.

The discussions about pay have been among the most heated. After the Obama Administration imposed a salary cap for banks that received bailout money, Kaden and other executives negotiated with Treasury officials to work out a different arrangement. The group, fearing that valued employees would bolt if their pay were cut, suggested that only the executive suite take the hit, leaving the bank's other top earners unscathed. Citi's response "paralyzed" regulators hoping to make examples of Wall Street fat cats, says one top executive at Citi. The pay discussions are ongoing. In June, the bank raised base salaries by as much as 50% for some top staffers.

Kaden is also a point man in discussions over the controversial pay package of top energy trader Andrew J. Hall, who is owed tens of millions based on a contract signed last year. The bank isn't caving to government pressure to rework the contract. Says a Citi spokeswoman: "We're confident in the value these types of profit-sharing arrangements bring to the company and its shareholders, as they directly align compensation with performance and include appropriate clawback and risk-sharing provisions."

If ever there were a time for Kaden to call on his Washington connections, it would be now. Kaden sits on the board of Human Rights First, a nonprofit advocacy group, alongside the new White House pay czar, Kenneth Feinberg. He also worked at Davis Polk with Citi's primary regulator, John C. Dugan, the U.S. Comptroller of the Currency. And he has known Larry Summers for more than 20 years.

With Citi at the mercy of regulators, "knowing your way around Washington has become more important than ever," says Brad Hildebrandt, chairman and founder of the legal consulting firm Hildebrandt International. "Having friends in high places is especially helpful." | BW |

LEWIS KADEN



Born

Mar. 24, 1942, Perth Amboy, N.J.

Education

BA, mathematics and history, Harvard College, 1963; JD, Harvard Law School, 1967

Current title

Vice-chairman, Citigroup

Positions of Influence

- Involved in public policy initiatives affecting tax reform, school finance, environmental policy. Worked for Senator Robert F. Kennedy and New Jersey Governor Brendan Byrne
- Represented Eastern, Pan Am, United, and pilots during consolidation of the industry

Family

Wife: Ellen Oren
Children (all Harvard grads): Douglas, 37; John, 35; David, 26; and Rebecca, 23

Business Exchange

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Pay Dirt

A July 31 report from the New York Attorney General showed that nine banks that received government aid doled out bonuses of nearly $33 billion last year despite booking losses of nearly $100 billion. Treasury Dept. pay czar Kenneth Feinberg has demanded that big banks each submit the compensation details for their 100 highest-paid employees, and is pushing to redo outsize packages.

To read the report go to **http://bx.businessweek.com/banking-industry/reference/**

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MANAGEMENT & LEADERSHIP

Barry Diller's Brash New Strategy

The former e-commerce impresario is placing a contrarian wager on "sponsored" Web content

By Ronald Grover

Few moguls have reinvented themselves more often than Barry Diller. Over the past 17 years he has been a TV executive, home shopping baron, and, most recently, e-commerce impresario. Now, Diller is at it again, and his Act Four is decidedly contrarian.

At a time when content providers are struggling to make money from online news, blogs, movies, music, and more, Diller is diving in. "[What] we're running now is a media-based interactive company," he says, speaking from his 300-foot yacht, *Eos,* off Indonesia. Yes, but what about the digerati who

"The era of a free Internet was created by technology people who wouldn't know content if they tripped over it"

insist "information wants to be free"? Diller is having none of it. "The era of a free Internet was created by technology people who wouldn't know content if they tripped over it," he says. "They had no idea how to monetize what people were watching."

So how will Diller make money where so many others have failed? He is creating a model where companies don't just sponsor or advertise against online articles and video, but also pay for customized content about their businesses—from three-part series to Web shows built around their products. Eventually, he also hopes to sell subscriptions for content, too.

LITTLE CHOICE

Diller's new vision isn't universally praised. "His media play is a bit of a long shot," says Cowen & Co. analyst Jim Friedland. The 67-year-old dealmaker has little choice but to look for new opportunities for his company, IAC. Last year, with IAC's stock languishing, Diller spun off Ticketmaster, mortgage site LendingTree, and HSN, the home shopping network. His two largest remaining assets—search engine Ask.com and the highly profitable dating site Match.com—are maturing. Friedland expects the shrunken and recession-hit IAC to earn $6.5 million this year on revenues of $1.3 billion.

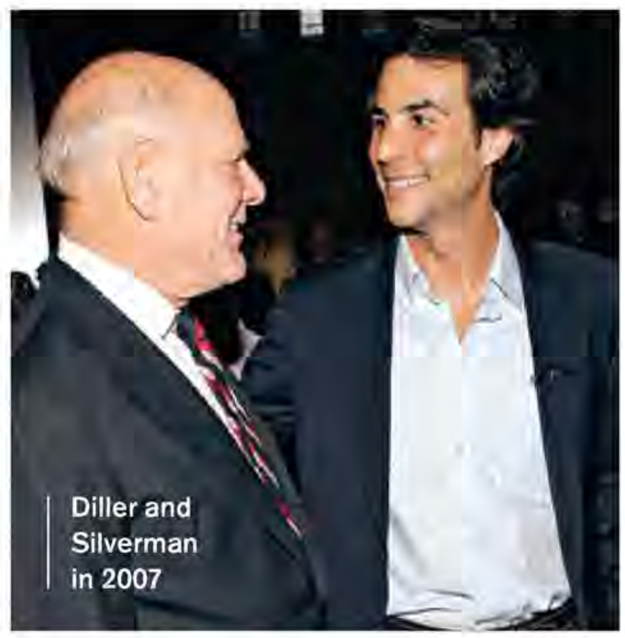
Besides the search engine and dating site, Diller owns ServiceMagic, which helps homeowners find plumbers and other contractors, and a handful of media sites he bought or launched that aren't yet profitable. Among the best known are GarageGames, which develops games; The Daily Beast, an artsy news site edited by celebrity editor Tina Brown; and the raunchy video site CollegeHumor.com. Last month, Diller agreed to seed former NBC programming chief Ben Silverman in a venture that will make TV shows for the Web.

Diller has put Ask.com at the center of his media ambitions. The site has 4% of the search market and depends heavily on Google-placed ads for its estimated $650 million in revenue. So Diller is creating channels that focus on specific markets. The first to sign on is Nascar. Ask.com paid the racing outfit an estimated $10 million to become the official search engine of the hugely popular car races. "Millions of Nascar fans are using Ask.com," says Nascar spokesman Andrew Giangola. Ask's news page displays racing news and results—even before national, business, and sports news. Traffic to Ask jumped after it started promoting Nascar in February, according to tracker ComScore. Fox has since advertised its Ben Stiller movie *Night at the Museum: Battle of the Smithsonian* on the Ask search page. Diller says he is looking for other sponsorship deals.

Diller's pure media sites are already well on their way. The Daily Beast recently ran a three-part series on Bottega Veneta, paid for by the luxury luggage maker; crime writer Patricia Cornwell paid the Beast to create a book channel featuring an excerpt of her latest novel. (Both were identified as sponsored content.) "Barry wanted us to make sponsored content interesting enough that it would become an interactive experience," says Daily Beast General Manager Caroline Marks. She figures as many as 20% of the series' readers clicked through to Bottega Veneta's ad, several times the normal rate.

CollegeHumor, meanwhile, created an entire episode of *Hardly Working*—a comedy about office slackers—around Nestea. The slackers drink Nestea for much of the show. In another segment developed for Colgate-Palmolive, a comedian repeatedly mentions the company's Wisp mini-toothbrush as he stumbles through New York City. Diller says the venture with ex-NBCer Silverman, though not yet fully fleshed out, eventually will charge advertisers to create Web shows that feature their products and services in the story lines.

The chameleon mogul acknowledges that his media ventures won't generate meaningful revenues for a while. "The time is coming when every newspaper puts its content behind walls, and people will have to pay," Diller says. "[But] it will be five years, maybe longer, before habits change." In the meantime, Diller will have to rely on ad revenues from Ask.com (which generates half of IAC's sales), subscriptions from Match.com, and payments from contractors using ServiceMagic. There isn't much wiggle room. The Ask advertising deal with Google expires in 2012. As Barry Diller returns to his media roots, he's placing a big bet on the notion that you actually can go home again. **BW**



Diller and Silverman in 2007

BILLY FARRELL/PATRICKMcMULLAN/SIPA PRESS

DILLER 4.0

The main pieces of the mogul's Web media company

Ask.com A distant third to Google and Bing, the search engine is creating niche channels for partners, including Nascar.

Match.com The giant dating site has 1.2 million subscribers who pay $21 a month. While profitable, it's maturing.

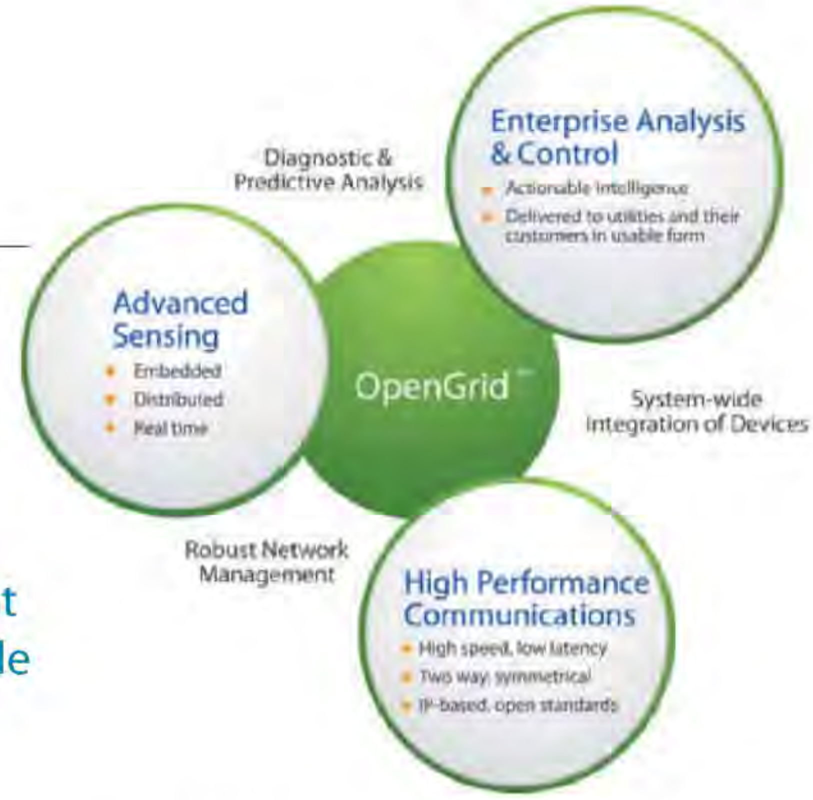
ServiceMagic It links homeowners with contractors, offers how-to videos, and features a comedy about an all-thumbs home-improvement expert.

The Daily Beast Its journalists cover U.S. news, arts, and culture, while the ad staff creates articles for sponsors such as Bottega Veneta.

CollegeHumor The raunchy comedy site produces Web shows that sometimes include heavy doses of sponsored content.

Data: *BW*; company reports; Cowen & Co.

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CURRENT's progress has been recognized by several awards including the World Economic Forum 2009 Technology Pioneer for its innovation, impact on business and society, future growth and sustainability, proven concept and visionary leadership; the GoingGreen East 50 Top GreenTech Companies; the Dow Jones 2008 Ten Most Innovative Clean Tech Companies in Europe; the 2006 Platts' "Global Energy Commercial Technology of the Year" for its technology in relation to emissions reduction, practicality, reliability and overall commercial success; and the Red Herring's 2006 "Top 100 North America." CURRENT, a private company headquartered in Germantown, Maryland, was founded in 2000 and has blue chip investors including EnerTech Capital, Google Inc., Goldman, Sachs & Co., and Liberty Associated Partners (an investment partnership between Liberty Media Corporation and the Berkman family), among others.

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Powering the Eco Economy

What's driving the urgency to create a stronger, better, smarter national energy grid? Age and neglect are highest on the list: the grid as we know it came to be in the 1960s, and it has gotten less and less care and feeding as the years have passed. Security threats are high on the list of contributors as well. Resource volatility, energy supply issues, and cyber and physical terrorism combine to create a frightening mix of 'what if' scenarios. Global warming and environmental sustainability are driving momentum toward a smarter grid.

As America steps up to reduce the carbon intensity of its power generation, organizations across the energy spectrum are working to green the grid.

America has a seemingly unquenchable thirst for electricity: Estimates are that the system will need to produce 50% more power in 2025 than it does now. In 1978, 8% of U.S. households had microwave ovens. Today, 83% have them. The size of a typical American home increased 40% between 1990 and 2006, and the explosion of computers, printers, and portable electronics means power production is racing to stay ahead of—or in line with—consumption. And with power demand accounting for 40% of CO_2 emissions, the U.S. faces significant challenges for producing power cleanly and efficiently.

"We have found that by using intelligent sensing and analytics to harvest the inefficiencies of the distribution grid itself, the yield can be significant, says Ray Gogel, President and COO of Current Group. Not only are we freeing up precious system capacity, but we are also eliminating the need for the generation of unnecessary power—even enabling utilities to monetize that asset. It's a win-win for both the environment and the consumers."

Starwood Is Blanketing China

The hotel chain's Sheraton brand has a cachet there that's likely to grow as Chinese tourism expands

By Christopher Palmeri and Frederik Balfour

On a recent business trip to Shanghai, Eagle Yin received all the perks of what he calls a "high-level international hotel." There was the free Internet connection, three in-house restaurants, a mah-jongg parlor, and an assortment of moon cakes, a Chinese delicacy, from which to choose. Moreover, the national sales director for Bayer HealthCare got all that for $80 a night at a Four Points by Sheraton, about 20% less than the average cost of a room in Shanghai.

For travelers who associate the Sheraton brand with plastic ice buckets and polyester bedspreads in the U.S., Yin's experience may come as a surprise. Like Buick, KFC, and Pizza Hut, Sheraton is one of those American names that may seem past its prime at home but is still popular and growing abroad. The hotel brand has particular cachet in China, going back to 1985, when it opened the Great Wall Sheraton Hotel Beijing. "Developers come to us," says Frits van Paasschen, chief executive of Starwood Hotels & Resorts Worldwide. "Within three years we'll have as many rooms in Shanghai as we do in New York."

Like a lot of U.S. companies being hammered at home, Starwood sees China as one of its best hopes for growth. The lodging giant, which also owns the upscale St. Regis, Westin, W, and Le Méridien brands, saw revenues fall 26% at its 1,000 hotels in the first six months of this year. While Chinese occupancy rates have suffered amid a decline in travel, analysts are optimistic. With a growing economy, China's banks are still lending and developers continue to bet on real estate. Starwood is planning to double the number of hotels it operates in China by 2012, to 100. And about two-thirds of those will operate under the Sheraton banner. Sheraton's average room rate of $138 internationally makes it a better bet to capture the emerging Chinese road warrior than the $223 average for a room at a W or $303 to stay at a St. Regis.





Van Paasschen (above) is opening more hotels like the Sheraton Suzhou (left)

(TOP) ETHAN HILL

Starwood anticipates that much of its growth will come from outlying regions. Although big cities such as Beijing now have a glut of rooms, thanks in part to the Olympics, there is growing demand for business-class accommodation in second- and third-tier cities such as Jiangyin and Dalian. Lower construction costs and inexpensive labor mean the company's Chinese hotel owners are able to offer guests a lot more frills than comparably priced U.S. properties.

In recent years the focus has shifted from international travelers to Chinese consumers. Starwood now asks its hotel staff to greet guests in Mandarin instead of English, which was long used to convey a sense of prestige. Many of its hotels do not label their fourth floors as such because four is considered an unlucky number.

Starwood is hardly alone in recognizing the potential of the Chinese market. Marriott International hopes to increase its China presence by 50% by 2014, to 61 hotels. "We're entering

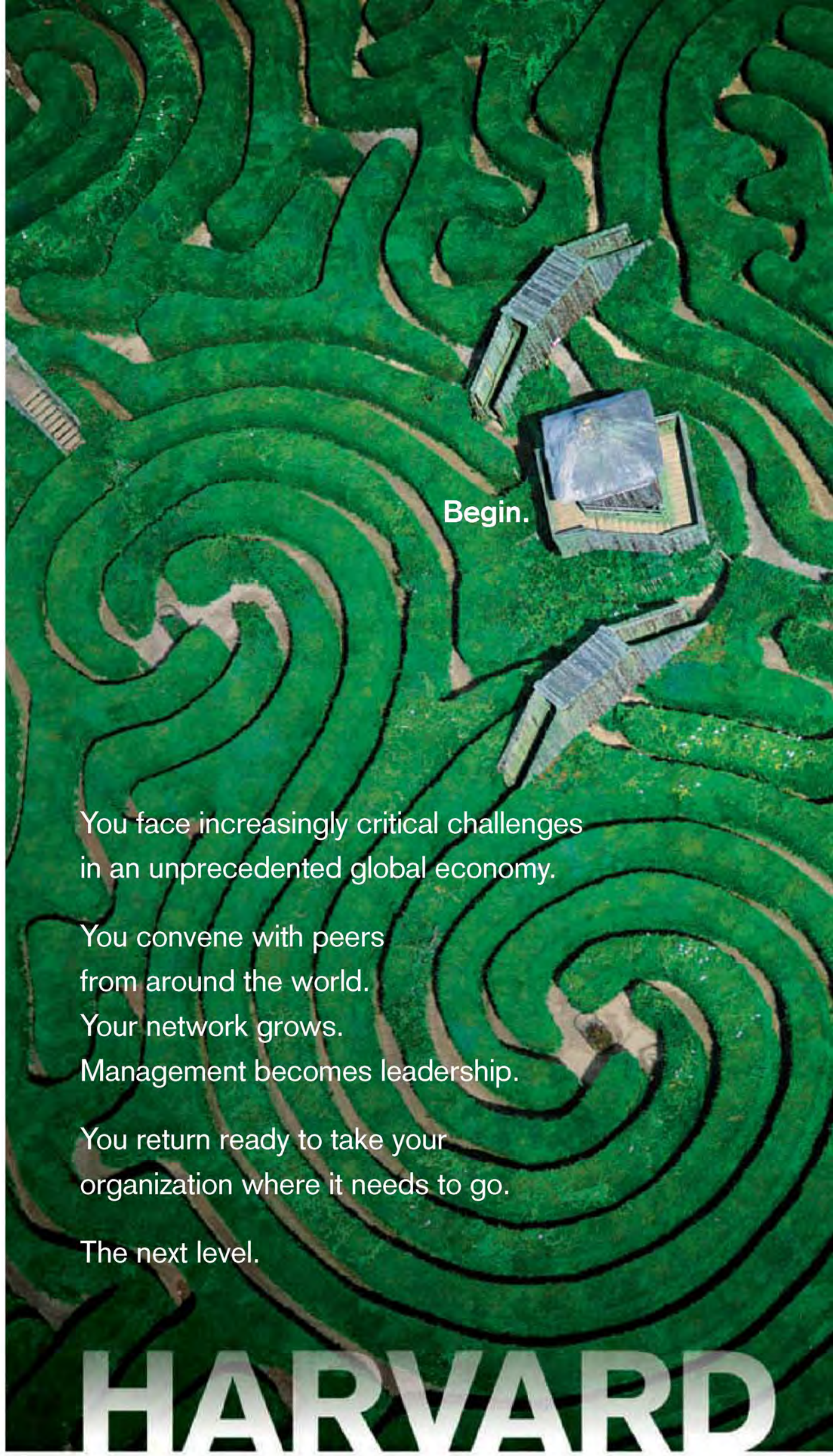
markets where the Marriott name is not present," says Edward Fuller, the company's president of international lodging. And InterContinental Hotels Group, parent of Holiday Inn, plans to double the 118 hotels it has in China over the next three years.

One major perk Starwood can offer over local competitors is its extensive global network and loyalty perks. More than 40% of its Chinese business comes through its Preferred Guest program, and Chinese membership in the program has jumped 50% this year. But local customers aren't particularly focused on accruing points to earn a free stay. They are "more interested in status," says van Paasschen, using points to get room upgrades, a free breakfast, or anything that accords them conspicuous V.I.P. treatment. Among other things, the preferred guest system allows staffers to see people's titles immediately. That makes it easier to give better rooms to managers than the subordinates they are traveling with, and to greet them first when a party arrives.

MIDDLE-CLASS DREAMS

After a long period in which Starwood paid more attention to its hipper W and Westin brands, the company recently has been remodeling its U.S. Sheratons. Among mainland Chinese travelers the Sheraton name has continued to exude an aura of international class. While that's helpful for Sheraton's domestic Chinese business, van Paasschen says the real potential comes when they start to travel. He hopes to lock in the loyalty of mainland customers now so they'll stay at a Sheraton when they start to travel abroad. "If you think back to the wave of Japanese tourists that came to the U.S. in the mid-1980s, we could have 100 million outbound trips from China," van Paasschen says.

Overall he sees a growing role for Sheraton in a world where expense accounts are heavily scrutinized and luxury seems almost taboo. "Half of humanity is middle class," van Paasschen says. "That middle class needs hotels." And the fastest-growing population of that middle class is in countries like China. | BW |



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EXECUTIVE EDUCATION

Europe's Bourses Are Losing Ground Fast

Electronic upstarts are luring scads of stock trades away from the lumbering old exchanges

By Mark Scott

As investors worldwide rush back to the market and trading volume surges, these should be fat times for Europe's big bourses. But with a slew of upstarts taking business away from the London Stock Exchange, Deutsche Börse, and other established exchanges, the old-guard trading venues are scrambling to hold on to their positions as the top places to buy and sell stocks.

The competition is starting to hurt. Two years ago the London Exchange accounted for 95% of all trades in Britain's leading stocks; in July that sank to just 64%, according to Thomson Reuters. In Frankfurt, the mighty Deutsche Börse watched its hold on German trading fall from a near-monopoly to 75% over the same period. By the end of next year, reckons financial consultantcy Celent, both exchanges could see their share drop below 50%. "Incumbents have been really slow to react," says Celent capital markets analyst Anshuman Jaswal.

The new entrants are low-cost electronic trading systems similar to those that took the U.S. by storm in the 1990s. Though not available to retail shareholders, they're heavily used by institutional investors such as hedge funds and investment banks. These outfits use the new platforms to trade large blocks of shares—typically the most liquid stocks listed on the big exchanges—while avoiding the relatively high fees charged by the bourses. More than a third of shares in telecom giant Vodafone, for instance, are now traded on the new platforms.

The upstarts have gotten a big boost from European Commission regulators. In November 2007—just as share prices were peaking—a rule change opened financial services to continentwide competition and required brokers to seek out the cheapest venues. Now, with shares finally climbing out of an 18-month funk, the old bourses are starting to feel the heat from the new rivals. "It's an inescapable trend: We're taking a larger slice of the pie," says Mark Howarth, chief executive of London's Chi-X Europe, which is now the region's third-largest trading platform, behind the LSE and NYSE Euronext.

Key to the newcomers' success is speed and low overhead. They execute trades far faster than the established players and employ less than a third as many people per million trades. So their fees are less than 10% of what the big bourses charge. "New technology and lower costs are what traders really want," says Mark Hemsley, chief executive of BATS Europe, a unit of Kansas City (Mo.)-based BATS Exchange, the third-largest U.S. trading platform.

LIGHTNING SPEED

In response, the LSE, Deutsche Börse, and NYSE Euronext have all slashed fees at least 25% since January and have started offering discounts to heavy traders. And taking a page from their rivals' playbook, some exchanges are launching their own low-cost platforms. Deutsche Börse's Xetra International, for instance, will make its debut in November in six countries.


Deutsche Börse in Frankfurt

HARTMUT SCHWARZBACH/ARGUS

No one expects Europe's big exchanges to disappear. Less sophisticated investors will still trade at the established venues, and revenues from other sources, such as new stock listings, will pick up as the economy recovers. The big bourses' days of monopolizing European trading, though, have drawn to a close. Says Phillip Silitschanu, European research director at financial advisory firm Aite Group: "The exchanges will have to learn to play nice with new competition." |BW|

INNOVATION & TECHNOLOGY

Is Merck Overselling A Cancer Vaccine?

Fresh controversies are heating up over the marketing of products to prevent cervical cancer

By Arlene Weintraub

The U.S. Food & Drug Administration is gearing up to make critical decisions about two controversial vaccines. On Sept. 9 an FDA advisory committee will consider whether Merck's Gardasil, given to girls to prevent cancer-causing human papilloma virus (HPV), should be approved for use in boys, who can be HPV carriers. The same panel will also advise the agency on whether it should allow a new HPV vaccine, GlaxoSmithKline's Cervarix, to enter the U.S. market. The FDA doesn't have to follow its panels' recommendations, but it usually does.

Sales of Gardasil to prevent cervical cancer hit a respectable $1.4 billion last year, but they are already starting to slump, and fresh controversies could pour more cold water on this whole class of vaccines. Ever since Gardasil was approved in 2006, health-care watchdogs have griped that Merck has been overselling the vaccine's cancer-beating power without having a full understanding of potential long-term risks. On Aug. 19, Columbia University professors Sheila M. and David J. Rothman published an article in the *Journal of the American Medical Assn.* blasting the company for paying grants to medical organizations that are strong advocates for vaccination. "Telling every mom she needs to get her daughters vaccinated to protect them from cancer is creating a market out of thin air," David Rothman says. "They're already protected" through regular pap smears, he adds.

Such criticisms mark a stark turnabout for a product once hailed as a breakthrough. Cervical cancer is a scourge: 11,000 cases are expected to be diagnosed this year, and 4,000 women will probably die of the disease, says the National Cancer Institute. The vaccine could prevent more than 70% of such cases. But from Day One, Merck has been lambasted for tactics such as lobbying lawmakers to make vaccination mandatory. After a strong start in the first two years, Gardasil sales fell 5% in 2008 and second-quarter sales are down 18% from a year earlier.

Dr. Richard M. Haupt, who heads the Gardasil research program for Merck, defends the company's marketing. "Our goal is to act in the best interest of public health," he says, noting that many organizations have spent money to promote the cause. Should boys be vaccinated? Merck has given the FDA data showing Gardasil prevents 90% of HPV symptoms in men, but since related male cancers are rare, the main justification is to protect their partners from cervical cancer. (Gathering data is also dicey because even if there were a drop-off in cases after widespread male vaccination, Merck could never prove its vaccine deserved more of the credit than, say, improved screening.)



HPV is a main cause of cervical cancer

CANCER VACCINES: BEHIND THE SCENES

Both Merck and GlaxoSmithKline are funding organizations that promote HPV vaccines for the prevention of cervical cancer

GLAXO	MERCK
$50,000 to the Gynecologic Cancer Foundation for an educational Web site on cervical cancer	$340,500 to the American Academy of Family Physicians for doctor education courses and a DVD on HPV
$125,000 to the Society of Gynecologic Oncologists for a 2009 meeting on women's cancers	$96,500 to the American College of Obstetricians & Gynecologists for courses and a CD-ROM

Data: Company disclosures

Glaxo, for its part, doesn't plan to market Cervarix to boys because it doesn't think the strategy would be worth the expense. The Centers for Disease Control estimates that vaccinating males would cost the health-care system at least twice as much per year of added life as it costs to vaccinate females.

As for payments to medical organizations, Glaxo, Merck, and their beneficiaries say their disclosures are adequate. Two recipients, the American College of Obstetricians & Gynecologists and the Society of Gynecologic Oncologists, say they put the money to many uses beyond endorsing a specific vaccine. Meanwhile, Merck's Haupt says the scandals are drawing attention away from what could be a public health boon. "I vaccinated both my daughters," says the father of four. And if Gardasil is approved for boys, he says, "I plan to vaccinate both my sons." | BW |

KWANGSHIN KIM/PHOTO RESEARCHERS INC

A Health-Care Trap For Small Business

An employee who gets seriously ill can push premiums so high that coverage becomes prohibitive



After a "requote," Mosley "can't afford another exorbitant increase"

By Joshua Kendall

SMALL BIZ

When it comes to health insurance, entrepreneurs are in a state of sticker shock. And it's not just the initial quote that has the power to astound. It's the wild premium increase that can accompany a single employee's unfortunate diagnosis. Wendell Potter, the retired director of media relations for Cigna, says those increases aren't always intended merely to cover insurers' costs. Instead, he says, they're sometimes levied with the aim of forcing a small company to drop its health insurance policy.

In June testimony before the Senate Commerce Committee, Potter said insurers "dump small businesses whose employees' medical claims exceed what insurance underwriters expected. All it takes is one illness or accident among employees at a small business to prompt an insurance company to hike the next year's premiums so high that the employer has to cut benefits, shop for another carrier, or stop offering coverage altogether—leaving workers uninsured. The practice is known in the industry as purging." In a

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THOMAS STRAND

February conference call with analysts, Cigna President David Cordani said: "In 2008 we were essentially actively decreasing our posture in several markets, particularly the under-50 book of business [companies with fewer than 50 employees]. You could use the term 'purge' if you'd like."

Few industry watchers are surprised. Says Len Nichols, director of the health policy program at the nonpartisan Washington think tank New America Foundation, of purging: "It's always gone on. It's the way business is conducted."

On Aug. 5, Senator John D. "Jay" Rockefeller IV (D-W. Va.) sent a letter to Cigna Chairman and CEO H. Edward Hanway requesting an explanation of Cordani's use of the word "purging" in the call, as well as the specific methods the company used to "decrease its posture" in the small-business market and how much money it has saved by doing so. Cigna has until Sept. 4 to respond. Cigna spokesperson Christopher Curran says that for small employers, "Rates are often based on claims experience. While we try to work with all our customers, when medical costs are higher than premiums, we may need to requote."

Joy Mosley, COO of Biotest Laboratories, a 77-person medical testing company in Minneapolis, recently got such a "requote" from her insurer, Medica, after an employee was diagnosed with pancreatic cancer. Medica covered the million-dollar treatment, but then said the large claim warranted $156,000 in additional premiums—a 72% increase. Larry Bussey, a spokesperson for Medica, says: "We don't purge. We try to keep our customers." Still, Mosley is terrified of the prospect of opening her next renewal letter, due any day. "We can't afford another exorbitant increase," she says.

FEW ALTERNATIVES

Not all entrepreneurs are equally vulnerable. About a dozen states prohibit insurers from basing premiums for businesses with 50 or fewer employees on workers' health status. But in roughly three-fourths of the country, so-called ratings bands allow for



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Compounding the problem is the fact that entrepreneurs, if slapped with hefty premium increases, may end up with fewer alternatives. In half of the states in the country, according to a 2008 survey by the Government Accountability Office, the largest small-business insurer has 47% or more of the market; in Alabama, one carrier insures 96% of all small businesses. "Such consolidation is an alarming trend," says Senator Olympia Snowe (R-Me.), the ranking member of the Senate Committee on Small Business & Entrepreneurship, which commissioned the study.

72%

The amount Biotest Labs' insurance premiums were set to rise after an employee got pancreatic cancer

In the absence of major policy changes, small companies have little leverage. "All any individual entrepreneur can do is to become more knowledgeable and to take the time to shop around for coverage," says Amanda Austin, director of Federal Public Policy at the National Federation of Independent Business.

A health insurance exchange, should it become part of a reform package, would provide protection against sudden rate hikes. However, even such a measure might exclude small companies with more than 20 employees. Says Nichols: "I'm very concerned about this. It will leave a lot of small businesses unprotected. The size really should go up to protect all firms that are not big enough to self-insure"—those with about 300 employees, he says. But the current proposals leave Biotest and thousands of similar companies out in the cold. | BW |

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MONEY REPORT

THE RISE OF A DIRTY OIL

On Aug. 20 the U.S. State Dept. approved a pipeline from the tar sands of Alberta to Superior, Wis. While the pipeline could deliver a relatively insignificant 800,000 barrels of oil a day to the U.S., its impact on the industry could be much larger. Oil's rally back to $70 a barrel makes the expensive extraction and refinement process for the kind of petroleum in tar sands, called bitumen, worth it. But processing bitumen produces more greenhouse gases than other kinds of oil. The State Dept.'s approval signals that it will put energy security over concerns about greenhouse gas emissions, says T. Rowe Price analyst Tim Parker. That could benefit engineering and construction companies such as Amec and Fluor, which are working on ExxonMobil's Kearl oil sands project in Alberta. Suncor Energy, a Canadian producer whose business is 70% tar sands, also could profit. Even after a 60% rally, the stock, at 32.08, "is reasonably priced," Parker says. *-Ben Levisohn*

TAX-EXEMPT BONDS

IS IT TIME TO INVEST IN LONG-TERM MUNIS?

Yields on tax-exempt bonds maturing in less than 10 years hit a six-year low in the week ended Aug. 21. With 30-year munis yielding near 5%—four percentage points higher than two-year munis—investors are shifting into the longer-term bonds. Is that smart right now? *–Lauren Young*



YES

Peter Hayes, *BlackRock*
Yields on short-term munis are extremely low. And long-term munis are scarce because of the success of Build America Bonds, which let municipalities issue long-term debt in the taxable market. That, combined with demand for 20- and 30-year munis, means investors in high tax brackets who aren't fearful of inflation can lock in higher yields now, since bond prices are likely to rise—and thus yields fall.



NO

Dan Genter, *RNC Genter Capital Management*
It doesn't make sense to own munis with maturities beyond 15 years, because investors aren't paid for the incremental interest rate risk and already get 80% of the yield of a 30-year bond. As more municipalities issue longer-term bonds and rates start to rise due to more supply and future inflation fears, there will be better opportunities to invest in 20- and 30-year munis.

EMERGING MARKETS

A HOT PLAY

Vietnam's General Statistics Office reported on Aug. 24 that the country's trade deficit in the first eight months of 2009 narrowed 67%, to $5.1 billion, from the same period the year before, thanks to improving exports. Vietnam's economic growth prospects look good, with IHS Global Insight forecasting a 4.7% increase in gross domestic product in 2009 and 6.2% for 2010, vs. -2.7% and 1.8% for the U.S. The Ho Chi Minh Stock Index, though still 52% below its March 2007 peak, has returned an average 20% a year since inception in July 2000.

Investors hoping to capitalize on the fledgling market's growth can use the recently launched Van Eck Market Vectors Vietnam exchange-traded fund, which currently tracks 28 companies that are either domiciled in Vietnam or generate more than 50% of sales there. Investing is not without risks: The ETF's prospectus warns that Vietnam's government may adopt rules that could—among other things—prevent the fund from repatriating its investments.
-Tara Kalwarski

MANAGED FUNDS

TIME TO TAKE ACTION?

By Tara Kalwarski

After the bear market wreaked havoc on your investments, did you kick any loser funds to the curb in favor of a simplified portfolio? If so, you're not alone. The trend to eschew actively managed mutual funds in favor of low-cost index funds has intensified during the recession, with investors adding more than $253 billion in funds with "passive" investing strategies since the end of 2007, vs. $72 billion taken out of active funds. In the first half of 2009, almost $22 billion in new cash was added to equity index funds, vs. $20 billion in net outflows for active stock funds. At the current rate, index funds will have amassed nearly 55% of all fund assets by June 30, 2019, up from 18% a decade earlier, according to data from Financial Research Corp.

The shift is understandable—actively managed funds lost more than index funds in 2008. But the timing is poor: Right now, there's a surprisingly strong case to be made for buying into actively managed funds.

The main argument is simply that the bargains are better than ever—even with the Standard & Poor's 500-stock index up 52% from its March low. Research published in May by Boston Company Asset Management, a subsidiary of BNY Mellon, found the downturn that dragged the S&P 500 near a 13-year low also had a big effect on valuation spreads, or the difference between where the cheapest companies in the index trade relative to the overall average.

Across most sectors, these spreads widened to levels not seen since 1952, presenting once-in-a-lifetime buying opportunities for active fund managers to load up on high-quality, heavily discounted stocks. Lately, some valuation spreads are looking even more attractive. And historically, active managers have most consistently outperformed following periods such as this, according to the report.

66%

Share of active managers that outperformed the U.S. stock market in the 10 years ended Dec. 31, 2008

Data: Vanguard

At the market bottom this past March, the average price-earnings ratio of companies in the S&P 500 was 10.0, vs. 3.9 for the 100 cheapest stocks in the index—a spread of 6.1. The spread currently tops 9.6 as disappointing earnings reports, coupled with rising stock prices, widened the range between the cheapest and most expensive S&P 500 companies. The p-e's for some S&P companies, including Abbott Laboratories, Apollo Group, and Dean Foods, have actually fallen since March.

The steepest discounts remain in what Robert Arnott, chairman of Research Affiliates in Newport Beach, Calif., calls the "loathed and unloved" sectors, including financial and consumer discretionary stocks. Active managers moving into these stocks are "buying greater long-term earnings potential," he says, because survivors will have less competition, and more pricing power and profits as a result.



BARRY FALLS



Outside of the S&P 500, alluring discounts also may be found among small- and mid-cap companies, where market prices don't necessarily reflect a company's fundamentals as well as they do with better-known companies, says William Droms, finance professor at Georgetown University's McDonough School of Business. Here, active managers are often able to add more value than their large-cap peers. That's because information about small companies is less readily available, so original research pays off. The same goes for international and emerging-market stocks, says Droms.

George Feiger, CEO of Contango Capital Advisors in Berkeley, Calif., believes the real plus of active management now lies in being able to avoid countries—and companies—still mired in debt. "As the economy recovers, those with low debt will grow, while the others will still be struggling," explains Feiger. (He favors China, Taiwan, and Singapore over debt-ridden countries in Eastern Europe and South America.)

A HARD SELL

But even though actively managed domestic equity funds have outperformed their benchmark indexes by about two percentage points on average so far this year, the fact remains that active investing largely failed to protect shareholders on the downside last year. In 2008, actives fell by an average of 40%, vs. a 37% loss for the S&P 500. A report written by Francis Kinniry Jr., a principal in Vanguard's Investment Strategy Group, found that over long periods, active funds trail index funds on account of their higher expenses. Research shows that "the No. 1 predictor of future outperformance is cost," he says. The average expense ratio of an actively managed equity fund in Morningstar's database is 1.13; among Morningstar's universe of top-ranked funds, it's 1.09.

Vanguard is known for its low costs, but it isn't betting against active funds. "We believe and are committed to both [index and actively managed funds]," says Kinniry. Still, 55% of assets under management (excluding money market funds) are in index funds, up from 47% five years ago.

Vanguard founder Jack Bogle, passive investing's most ardent fan, is "more convinced than ever that indexing works." He has perhaps the best advice on how to choose an active fund: "Look for a management company that is in the business of managing money and not making money." He suggests examining a fund shop's "stewardship." Morningstar assigns letter grades to each fund as a measure of how responsibly the parent firm treats investors. The rating is scored across five categories: regulatory issues, manager incentives, board quality, corporate culture, and fees.

Whether you go the active or passive route, Bogle reminds investors that, above all, the concept of buy and hold is most important. "When we lose, we get out [of the market]. And when we win, we get in," he says, meaning that investors tend to sell low and buy high. "We are our own worst enemy." | BW |

PICKING WINNERS

All of these actively managed funds get an A for stewardship from Morningstar, thanks to their top-notch management companies and fees that are below-average for their fund category.

NAME/TICKER	RETURN SINCE INCEPTION*	COMMENT
Vanguard Wellesley Income/VWINX	10.1%	Morningstar gives this balanced fund five stars for its fat yield and moderate risk. More than 60% of assets are in cash and bonds now.
Davis N.Y. Venture/ NYVTX	11.7%	Davis is a large-cap fund with a 0.85% expense ratio and gets kudos for a consistently applied investment approach since its 1969 launch.
Dodge & Cox Stock/ DODGX	10.7%	Vanguard's Jack Bogle recommends this firm "without hesitation." Morningstar likes this large-cap fund's "strong long-term record."
FPA Capital/FPPTX	9.6%	This mid-cap fund has returned 8% a year since 1999.
Oakmark Equity & Income/OAKBX	11.1%	Oakmark's 10-year return ranks it No. 1 in its category, and the fund has been closed and reopened at times to protect shareholders.
Diamond Hill Small Cap/DHSCX	10.0%	This $486 million small-cap fund has been around only since 2000, and its small asset base makes it more nimble than some of its peers.

Data: Morningstar *Average annual return as of Aug. 21

A RADICAL RETHINK OF R&D

(FROM PAGE 035)

By Aaron Pressman

Betting on trends in technology isn't a short-term proposition. But too many analysts and investors concentrate on relatively minor quarter-to-quarter scuffling between the tech giants, says Pip Coburn, a former technology analyst himself. Coburn, who left Wall Street in 2005 to found Coburn Ventures, runs a tech-oriented hedge fund that looks for deeper trends that may fuel new industries or destroy existing business models.

Coburn's fund doesn't just buy and sell technology stocks short. When it comes to making bets on how major tech trends may help or hurt different industries, the fund casts a wider net than many of its peers. Coburn foresaw how the Internet would destroy the newspaper industry's business model and shorted the sector back in 2007, for example. Lately, Coburn sees about two dozen serious tech-related shifts on the horizon. Here are three of the major themes he is following now and some stocks in his fund that may benefit.

Coburn's tech-oriented hedge fund casts a wider net than many of its peers

DATA, WITH A TWIST

The theme: With more and more of people's lives being led online, from entertainment to communication and commerce, the world is awash in a sea of data. "There is so much data out there today, it's not O.K. just to have a massive amount [of it] anymore," says Coburn. "Now companies had better figure out how to use it wisely." To make a difference to the bottom line, companies have to harness the data and offer a twist—make it mobile or deliver analysis quicker.

The play: ANSYS, a data-modeling company outside Pittsburgh, uses "real world" data to create computer models. Its programs do everything from measuring car safety without a single crash-test dummy to figuring out how giant cargo ships can be designed to stand up to stormy ocean conditions. The company's operating profit margin is more than 30%, and revenue grew an average of 45% a year from 2006 through 2008. Shares of ANSYS, which are down 18% for the year, recently jumped to 36 from 31, on better-than-expected earnings.

POPULATION CHANGE

The theme: Human population has doubled over the past 50 years and could double again, to 14 billion, in the next 50. That means more demand for food, energy, and everything else even as the availability of natural resources diminishes. Coburn says the trend will boost a wide array of industries such as water, alternative energy, and "clean tech" providers.

The play: Monsanto, the seed and herbicide giant, will be one of the biggest beneficiaries as the population increases, says Coburn. Even if the figure levels off in the next few decades, farmers will still need to grow more crops more efficiently. So Monsanto's innovations in agriculture will be in high demand, he figures. The stock is down 31% in the past year and trades for less than 20 times its expected 2010 earnings.

DIGITAL DEMOGRAPHICS

The theme: Older folks who were not weaned on technology are increasingly interested in getting up to speed, whether it's to succeed at work or look at photos of the kids online. They are in search of what Coburn calls "digital ferrymen" who can assist them.



JASON GROW

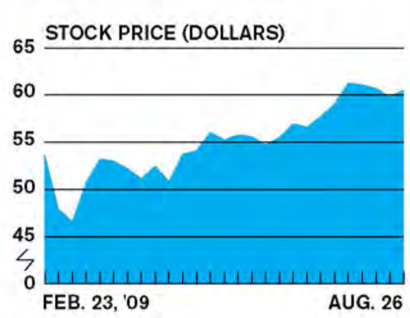
The play: One obvious beneficiary of this theme is Apple, which emphasizes how easy it is to use its software and hardware products, says Coburn. Another company he says is well-positioned is Strayer Education, which operates adult education schools in 12 states and is expanding rapidly. Revenue was just under $400 million last year with almost 45,000 students enrolled. "It's still a modest company," says Coburn. "But they could become the dominant brand—a household name—over the next few years." | BW |



ON THE MEND AT J&J

Sales and earnings gains have been limping lately at Johnson & Johnson (JNJ), a diversified global leader in pharmaceuticals, medical devices, and consumer products. But the stock certainly is not on crutches. It's trading at 60.64, up from 46 in March. Some pros predict it will rise even higher with the economic recovery.

J&J STOCK IS RECOVERING FAST



Data: Bloomberg

"J&J deserves a much higher valuation, based on its stable earnings growth and below-average debt," says Terry Morris of National Penn Investors Trust, which owns shares. J&J trades at a depressed price-earnings ratio of 12.5 (on a projected 2010 profit of $4.88 a share) vs. an average p-e of 18.5 in 2005. Morris expects earnings to grow 8% annually for the next three to five years. And with a dividend yield of 3.2%, J&J's intrinsic value is 96, he figures.

J&J earned $4.57 a share in 2008. The consensus estimate for 2009 is $4.52, notes Zacks Investment Research. In 2011, J&J is expected to earn $5.39. Its 250 operating entities worldwide are projected to post sales of $60.6 billion in 2009 and $63.6 billion in 2010, vs. 2008's $63.7 billion.

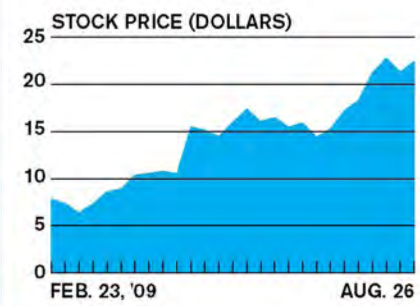
Herman Saftlas of Standard & Poor's, who rates J&J a buy, says its diversified sales base and decentralized model will serve it well in the years ahead. He also sees promise in its pipeline of new drugs, such as Simponi for arthritis.

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BRAD TRENT; CHARTS BY DAVID FOSTER

CLIMBING AT EXPEDIA



Data: Bloomberg

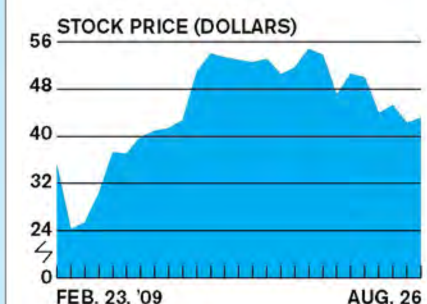
Why Expedia Has Taken Off

Weak consumer spending should have clobbered Expedia (EXPE), one of the top online travel companies. But it hasn't. Instead, Expedia has thrived recently. The company beat analysts' forecasts in the second quarter despite a slowdown in travel bookings.

"Expedia's cost management, solid financials, and a favorable online ad environment" helped boost results, according to Zacks.com, which upgraded the stock to outperform from neutral. Expedia trades as if there were no recession, rocketing to 22.86 on Aug. 26 from 6 last Nov. 21. The key to future growth, he says, is its rapid expansion overseas.

Rating Expedia (a client) a buy, Justin Post of Bank of America Merrill Lynch says it's gaining share as travelers increasingly turn to booking their trips and hotels online. Post sees Expedia earning $1.26 a share in 2009, $1.43 in 2010, and $1.58 in 2011, up from $1.25 in 2008.

IS AMAG SET TO SOAR AGAIN?



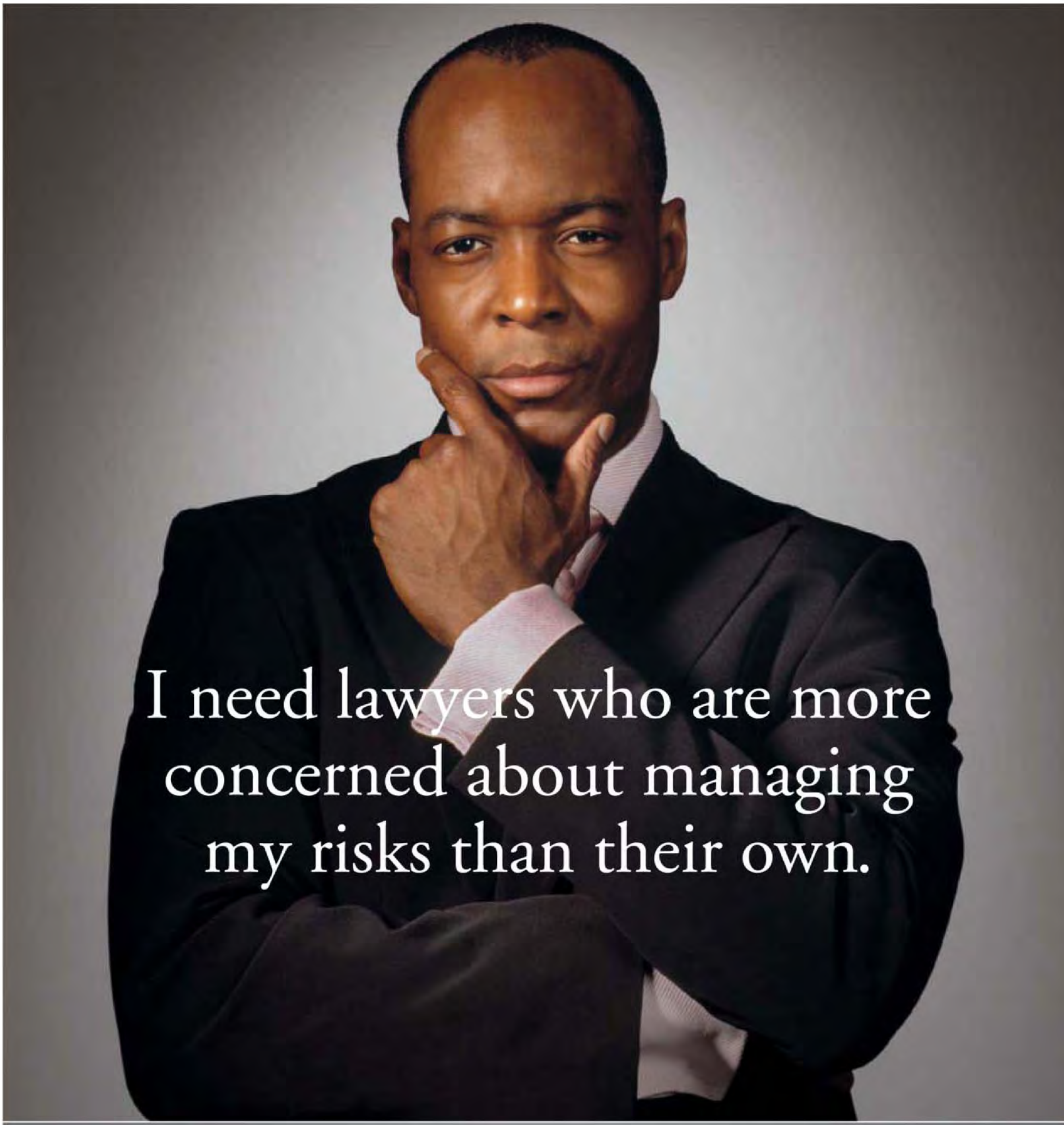
Data: Bloomberg

A Biotech Tackles Anemia

Hardly a household name, AMAG Pharmaceuticals (AMAG) is nevertheless catching many an investor's eye. The stock defied the odds when the market was in a downspin: It zoomed to 58 on July 1, up from 18 in November. It has since eased to 42.28, but analysts see the stock advancing again since the Food & Drug Administration's approval in June of AMAG's Feraheme. This is an injectable treatment for iron-deficiency anemia in chronic kidney disease.

Analyst Mark Monane of Needham (it did banking for AMAG), who tags the stock a buy, says AMAG has the opportunity to use Feraheme in both the dialysis and nondialysis markets.

Yaron Werber of Citigroup Global Markets also rates AMAG a buy, with a 12-month target of 65. He says many blood cancer patients suffer from chronic kidney disease, and this represent a substantial market for Feraheme. |BW|



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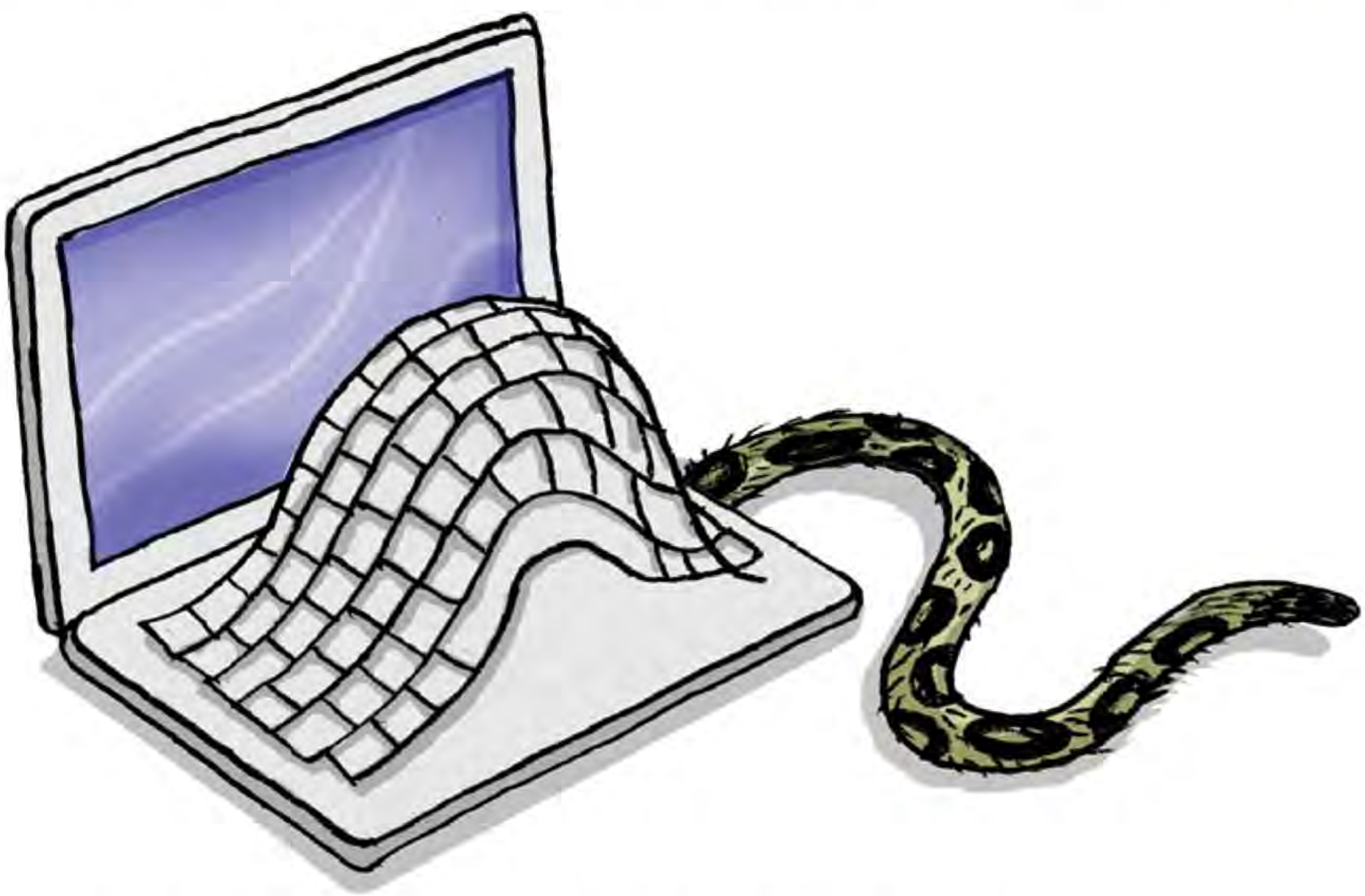
BUSINESS VIEWS

TECH & YOU | STEPHEN H. WILDSTROM



Mac Relief for Microsoft Users

Apple's Snow Leopard upgrade has something practical for those with mixed loyalties



BRAD TRENT; ILLUSTRATION BY DAVID GIBSON

New versions of Apple's Mac OS X software usually make a big visual splash. But Snow Leopard, the operating system that's available on Aug. 28, is so short on eye candy that it was hard for me to tell anything had changed after I installed it on my iMac. In contrast to Windows 7, where Microsoft focused on fixing the dismal experience of using the Vista operating system, Apple concentrated on improving OS X's underpinnings.

The result is a winner, mainly because Snow Leopard has built-in support for Microsoft Exchange. This makes it much easier for people in a Microsoft work environment either to use a Mac on the job or to get to their mail, contacts, and calendar from a Mac at home. For anyone who has struggled with such tasks in the past, Snow Leopard (officially OS X 10.6) is well worth the bargain price of $29, or $49 for a family pack that's good for up to five computers.

Until now, Mac users had two less-than-ideal ways to get access to Exchange. Office 2008 for the Mac includes a program called Entourage, a pale imitation of Outlook that lets you into your Exchange mailbox with limited access to contacts and calendar. The more ambitious approach was to set up Windows on the Mac, using Parallels or VMware virtual machine software, and then run Outlook itself. Microsoft has responded to Snow Leopard by promising real Outlook for the Mac—but not until late next year.

There's no reason to wait. Once you upgrade to Snow Leopard, you should be able to add your Exchange account to your Mac without help from your IT



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department. You just enter your e-mail address and password in the Mail application, and you will see your messages, along with to-dos and notes. The iCal scheduling program takes care of appointments and other calendar items. Address Book deals with contacts, including the global address list, a big deal for Exchange users. The one catch is that all of this works only with Exchange 2007, the latest release. Quite a few large organizations run older versions of the software.

Much of the effort behind Snow Leopard went into building a software platform for the future. Most new computers have 2 or 4 processors, and that will soon increase to 8, 16, or more. But today only the most skilled programmers know how to use this power efficiently when they are writing applications that users crave. A new technology in Snow Leopard, called Grand Central Dispatch, is designed to make it easier for developers to create programs using multiple processors, reducing the wait for a processor to finish a task. The result should be more powerful and smarter software for everything from games to home automation.

Another advance in the operating system, called OpenCL, lets programs take better advantage of powerful graphic adapters in many current computers. Snow Leopard also completes the transition from 32-bit to 64-bit computing, which enhances performance and allows the use of vast amounts of memory. Unlike in the Windows world, where this transition is still causing pain and limiting the memory of many Windows 7 systems to an increasingly inadequate 3 gigabytes, Apple has pulled it off seamlessly. Finally, Snow Leopard marks the end of the transition from the old PowerPC chips to Intel processors; the software only runs on Intel-based Macs. (Apple completed the switch to Intel chips in late 2006.)

The new operating system isn't completely devoid of flashy features. For example, Chinese speakers can write ideograms on the touchpad of a MacBook, and the software will produce the correct Chinese character in the text. Such frills aside, Snow Leopard is an unusual Apple offering, being nearly all steak with very little sizzle. But it is an inexpensive and painless upgrade. If you have an Intel-based Mac, and especially if you use Exchange mail, you'll want to install it. | BW |

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What Makes Snow Leopard Purr?

Grand Central Dispatch and OpenCL are two important new technologies built into the latest version of the Mac operating system. Both are designed to make it easier for software developers to take advantage of the multiprocessor design of current and future computers. One of the best places to learn how they work is in reader-friendly white papers on Apple's Web site.

For links to these papers and other related stories, visit **bx.businessweek.com/apple/reference/**



Harry and Louise on Steroids

Why issue and advocacy advertising has become such a growth business

You don't hear much about individual advertisers that are spending more in these straitened times, much less entire categories of advertisers doing so. But this is exactly what's happening with political advertising. ¶ Yes, the debate over health care has advocacy group after advocacy group advertising all over TV and the radio dials. They're spending more than a million bucks a day, says Evan Tracey, who tracks political ad spending for media tracker TNS Media Intelligence (which provided the ad data presented herein). But the bigger story goes beyond health care, which through Aug. 19 this year had not yet accounted for 20% of all paid political advertising. For the foreseeable future, and for that matter probably forever, we are in a world where major legislative battles will be accompanied by major ad campaigns. Consider the next batch of issues likely to turn up in congressional bills: card check, immigration reform, cap and trade. "There is a glut in the pipeline" of such broad-gauged issues, says Jeff Eller, vice-chairman of political communications firm Public Strategies. And they all come festooned with several hot buttons for opponents to press. All have significant implications for Big Business, which will be all too happy to buy ads by the metric ton to put forth their views to sway undecided voter blocs or pressure those who barely won their congressional seats last time around.

The fundamental truth about political advertising is that it's never been particularly affected by gravity. Unlike other categories, political ad spending has gone up from election cycle to election cycle. Anyone who thinks off-year, issue-related advertising will wither once the current controversies have faded is betting against reality. "The notion there are off years" in politics, says Tracey, "has been proven completely phony."

There is nothing new about spending significant dollars on issue advertising in the year following an exhausting Presidential election. What's changed is the sheer scope of such spending. Ads against and for President Bill Clinton's health-care plan in 1993 and 1994 cost at least $18 million. That's more than $26 million in 2009 dollars, but chump change by current standards. Through



mid-August, $436 million had been spent on issue-related ads this year. This already dwarfs what was spent in the last comparable post-Presidential election year of 2005—and bear in mind this is the alleged dog-days lull and that an actual health-care bill doesn't even exist yet to agitate for or against. Also, though I hate to remind you, the 2010 election machine is just starting to gear up, meaning an avalanche of candidates' ads soon will be landing at radio and TV stations across the land. Excuse me, did I say, "soon will be"? In several states—among them Connecticut, Florida, Kansas, New Mexico, and Virginia—they're already there, and have pushed total political outlays thus far this year to a bit less than $520 million. Meanwhile, the dynamics of such spending have been noticed, to put it mildly, at TV stations. "It looks to me like a record off-year" for political spending, says John Hendricks, an executive vice-president of Tribune Broadcasting, "driven by issue and advocacy money."

The overwhelming majority of these political ad dollars is being spent on TV. TNS data show that this year around 96% of political spending went there. (Forget the digitizing of the ad landscape when it comes to politics. As with the Obama campaign of '08, the Web is used almost exclusively to raise funds and push news to the already committed rather than sway the undecided.)

Public Strategies' Eller, for one, disputes that political spending is on an ever-upward trajectory. He suggests that one factor driving this year's glut of political TV ads is the downturn in television ad revenue, which positions politicos to negotiate better deals than ever before. But clearly more than mere pricing has led to a truckload of issue ads. While the $2.8 billion spent on political advertising in the Presidential election year of '08 didn't match what Procter & Gamble alone spent on ads, I suspect media executives are glad to have a category worth several hundred million dollars that's growing by leaps and bounds in an off year—and all the more so if they own a bunch of TV or radio stations in swing states. | BW |

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For Jon Fine's blog on media and advertising, go to businessweek.com/innovate/FineOnMedia.

(TOP) BRAD TRENT; ILLUSTRATION BY MARK TODD

The Real Mother of Invention

How cherry-picking and then melding ideas from a wide range of disciplines can lead to a eureka! moment

The author of *Borrowing Brilliance,* David Kord Murray, has an impressive résumé. Not only is he a rocket scientist who worked on numerous projects for NASA and the Pentagon but he's also a successful entrepreneur, having sold Taxnet, a company he co-founded that specializes in e-filing software, to H&R Block in 2005. And in between those items on his CV is a strong hint that he practices what he preaches. When Murray was head of innovation at Intuit—the creator of TurboTax, which allows users to e-file—he saw a brilliant idea, borrowed a chunk of it, and made a killing. His book encourages everyone to give it a try. After all, he argues, it worked for Johannes Gutenberg, George Lucas, and the Google guys.

Murray uses personal anecdotes and scores of examples to build the case that cherry-picking the ideas of others is a vital part of the research and development process. For instance, Google is heralded for borrowing concepts from library science to improve Web searches. Gutenberg's printing press borrowed from the gear used by winemakers and olive-oil producers. George Lucas? It's a longish list. Such nuggets spice up Murray's six steps, which start with defining the problem you want to solve, then searching for solutions used by others with similar problems, followed by a process of refining the material you gather.

As he lays out his method, he raises the stakes on innovative thinking. It's more than just a competitive advantage. These days it's a lifeline. "The need for innovation and creativity becomes more and more important as ... product and career life cycles become shorter," Murray writes.

In a sense, this book is an idea Murray borrowed from himself (and Intuit, again). In the early 2000s he was asked to create an innovation training program for the company. The goal: a clear, easy-to-replicate process for creative thinking. After studying hundreds of inventive thinkers, from Charles Darwin to Apple CEO Steve Jobs, he concluded that the quickest and most reliable path to invention is paved with appropriated ideas. That may not strike you as terribly original, but Murray's method involves mixing and matching the concepts of others, ideally from disparate fields, to arrive at something new.



***Borrowing Brilliance: The Six Steps to Business Innovation by Building on the Ideas of Others* by David Kord Murray; Gotham; 293 pp.; $26**

Murray himself is a study in reinvention and, despite his résumé, failure. Back in 1999 he passed up a $25 million offer from GE Capital for the office-equipment financing firm he'd built and opted for a higher offer from a bank. But the Federal Deposit Insurance Corp. shut down the overleveraged bank, which Murray doesn't name, and he was left on the hook for $30 million in new loans signed while he was negotiating the deal. Beyond broke, he spiraled into alcoholism.

The best ideas to borrow often come from far afield. Gutenberg borrowed from winemakers, while Google tapped library science

After well over a year he rang up the GE executive who tried to buy his company—and who had since moved to Intuit—to ask for help. Murray was initially given a shot at revitalizing the direct-marketing campaign for TurboTax. The idea for doing so came through his mail slot. At that time, AOL was sending software upgrades to customers on CDs. Murray advised Intuit to send past customers disks with updated TurboTax software on them. If they paid online or on the phone, they could unlock it. Suddenly the response rate to Intuit's direct marketing jumped from 15% to 60%.

But Murray keeps his personal history from playing too big a part. Instead, Jobs pops up a lot, even though Murray, who's clearly an admirer, didn't interview him. He relies on often familiar stories to portray Jobs' notorious ability to co-opt the ideas of others. "Sadly, I'll never be Steve Jobs, and neither will you, but I can simulate the way he thinks even if it isn't inherent in me. And you can, too," he writes.

The strongest advice in the book is Murray's notion that the best ideas to pilfer are the least obvious. "The farther away from your subject you borrow materials from, the more creative your solution." Murray repeats his main points—even some anecdotes. But his aim is to demystify the thing that makes many a manager sweat profusely. And he's living proof the method can produce results. | BW |

BUSINESSWEEK.COM | **Meet the author:** To watch a video interview of author David Kord Murray by Reena Jana, go to businessweek.com/go/09/murray

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2	**HOW THE MIGHTY FALL** Jim Collins (Jim Collins $23.99) The seeds of decay can be sown—unnoticed—while a company rides high.	2	3
3	**THE ACCIDENTAL BILLIONAIRES** Ben Mezrich (Knopf Doubleday $25) An unflattering portrait of Facebook founder Mark Zuckerberg.	—	1
4	**A COLOSSAL FAILURE OF COMMON SENSE** Lawrence G. McDonald and Patrick Robinson (Crown $27) Lehman's collapse, up close.	—	1
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7	**MADE TO STICK** Chip Heath and Dan Heath (Random House $25) Six reasons why some ideas catch on while others wither away.	9	23
8	**STRENGTHS-BASED LEADERSHIP** Tom Rath, Barry Conchie (Gallup Press $24.95) The three keys to being a more effective leader.	5	7
9	**TRIBES** Seth Godin (Portfolio $19.95) A man, a plan, and a group of followers—that's what you need to foster innovation.	—	7
10	**FOOL'S GOLD** Gillian Tett (Free Press $26) JPMorgan's role in creating innovative and destructive derivatives.	3	3

PAPERBACK BUSINESS BOOKS

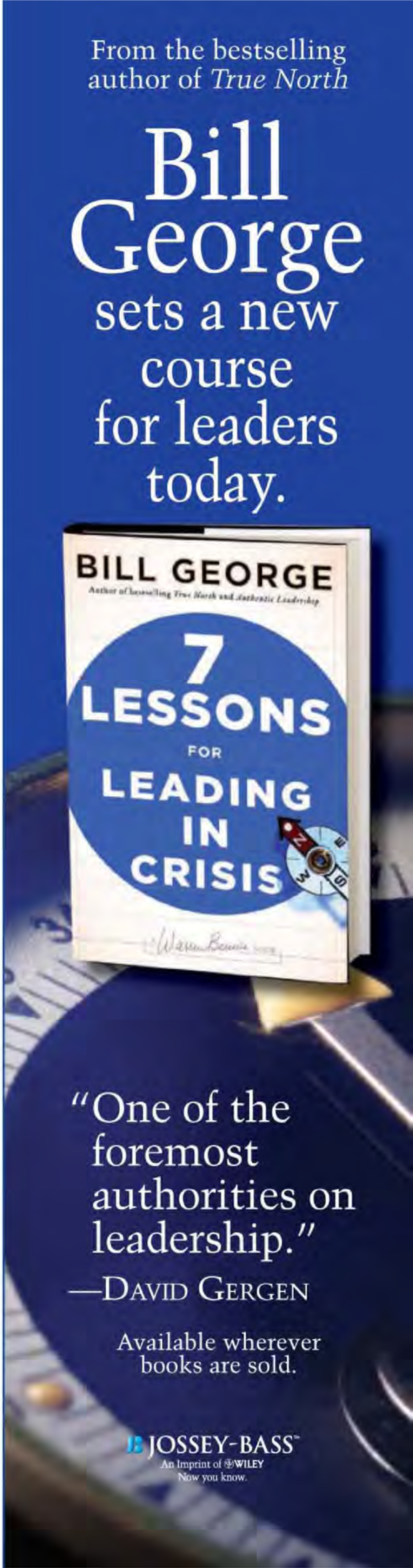
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1	**SWAY** Ori Brafman and Rom Brafman (Doubleday $21.95) Rational explanations for the irrational decisions most people make.	7	2
2	**THE SPEED OF TRUST** Stephen R. Covey (Free Press $15.95) Nurturing credibility in your personal and professional lives.	5	18
3	**WHAT COLOR IS YOUR PARACHUTE? 2009** Richard Nelson Bolles (Ten Speed Press $18.95) The enduring job-search bible.	4	11
4	**NUDGE** Richard H. Thaler and Cass R. Sunstein (Penguin $16) Why we make flawed decisions and how we can start making better ones.	3	5
5	**SUZE ORMAN'S 2009 ACTION PLAN** Suze Orman (Spiegel & Grau $9.99) Safeguards to put in place and mistakes to avoid.	1	8
6	**MICROTRENDS** Mark J. Penn with E. Kinney Zalesne (Grand Central $14.99) Small changes that are having an outsize impact.	—	1
7	**DEBT CURES "THEY" DON'T WANT YOU TO KNOW ABOUT** Kevin Trudeau (Equity Press $14.95) How to turn bad debt into good credit.	6	3
8	**HOW TO MAKE MONEY IN STOCKS** William J. O'Neil (McGraw-Hill $16.95) A seven-step system for balancing gains against risk.	2	12
9	**THE GOAL** Eliyahu M. Goldratt and Jeff Cox (North River Press $24.95) Aligning company strategy with priority No. 1: Making money.	14	16
10	**THE NEW RULES OF MARKETING AND P.R.** David Meerman Scott (Wiley $16.95) Harnessing the Web to reach the customer.	8	6

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LONG-RUNNING BEST SELLERS

HARDCOVER BUSINESS BOOKS **StrengthsFinder 2.0** Tom Rath (Gallup Press $21.95) ▪ **Good to Great** Jim Collins (Collins $29.99) ▪ **Five Dysfunctions of a Team** Patrick Lencioni (Jossey-Bass $24.95) ▪ **The Total Money Makeover** Dave Ramsey (Thomas Nelson $24.99) ▪ **Who Moved My Cheese?** Spencer Johnson (Putnam $19.95) ▪ **The 4-Hour Workweek** Timothy Ferriss (Crown $19.95)

PAPERBACK BUSINESS BOOKS **The Tipping Point** Malcolm Gladwell (Back Bay $14.99) ▪ **Getting Things Done** David Allen (Penguin $16) ▪ **The 7 Habits of Highly Effective People** Stephen Covey (Free Press $15.95) ▪ **Blink** Malcolm Gladwell (Back Bay $15)



074 FEEDBACK

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HEALTH REFORM

FURY AT INSURERS

"Why Insurers Are Winning" (Cover Story, Aug. 17), about how insurers are maneuvering behind the scenes to shape health-care reform, provoked a town hall–style shouting match on businessweek.com. Many commenters were incensed that UnitedHealth and other carriers hold so much sway over Congress, though a United employee vigorously defended the company, saying it knows health care "far better than the policy wonks in Washington." *–Chad Terhune*

UnitedHealth's attempt to snow Congress with technological bling is just their style—to confuse and distract from the ultimate issue: that insurance companies take 35% of premiums off the top.

Screen name: Dr. Fred



Unless something drastic happens, I believe it will be just as *BusinessWeek* says: any original good intentions in this legislation will be so watered down as to be negligible, and Big Insurance will get even bigger.

Screen name: Jules Robertson

No, the insurance industry hasn't won yet, but there may not be enough Democrats with a spine to resist.

Screen name: chuck

My blood froze as I read this article. What gives corporations the sacrosanct right to profit from my health care when the government can do it better and more cost effectively?

Screen name: FredTheDistraught

I am a policy wonk and not a fan of the big insurers. But United is right about the public plan. Medicare pays providers 20% to 30% less than private insurers. Providers shift the costs to private insurers. The public plan will have lower premiums. Within 4 to 5 years, the private insurers will be out of business.

Screen name: Sam

Let's see. We're going to spend less for health benefits and yet United expects to make higher profits? Our representatives are already working with the insurance industry to "constrain" benefits [for the newly insured]. Sounds a lot like rationing—by a huge for-profit industry that rewards its executives for acting as if they work on Wall Street.

Mike Zigelman, MD
ARROYO GRANDE, CALIF.

I am an RN working for UnitedHealth. What I have been told repeatedly is that quality is our cornerstone. No one has ever suggested I shortchange any member's services in the name of profit.

I am proud that United has a hand in health-care reform. They know health care far better than the policy wonks in Washington.

Screen name: Another UHG Nurse

TRANSPORTATION

SHORT SHRIFT FOR HIGH-SPEED RAIL

"Small Airports Drop Off the Radar" (What's Next, Aug. 17) reports that Congress gave $1.8 million in federal subsidies to a small airport in Ely, Nev., that served 414 passengers last year. Amtrak gets an annual subsidy of about $50 per passenger. I don't begrudge the 4,041 residents of Ely their air service, but imagine the high-speed rail we could have for $4,500 per passenger!

Steve King
GERMANTOWN, MD

BUSINESS CREDIT

WHEN BANKS DECIDE NOT TO LEND

Like Norwalk Furniture, my business has been seriously impacted by my bank's refusal to provide additional credit during this crisis ("The Factory That Refused To Die," In Depth, Aug. 3).

I've done business with Banco Popular for more than 20 years. It holds the mortgages to my business and home and has financed company cars. We have an excellent credit rating. Not only has the bank said no to a loan for a government project; it also wants to reduce our credit line.

We've found another bank willing to work with us. I urge business owners in the same situation to visit other banks and talk to the managers. Smart ones can distinguish good customers from dunderheaded CEOs.

Benjamin Brown
Schafer & Brown Electronics
CABO ROJO, PR

CORRECTIONS & CLARIFICATIONS
A chart entitled "A Brief History of Optimism" (Special Report, Aug. 24 & 31) mislabeled the axis displaying the Dow Jones industrial average. The highest level should have been marked 12,000, not 1,200.

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This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names.
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Building Trust by Trusting

We all want loyal customers and employees, but are you willing to meet them halfway?

The world's financial markets nearly collapsed last fall for one reason: lack of trust. Credit, the lifeblood of the global economy, all but stopped flowing. Even big banks refused to lend to each other because they didn't trust they would be repaid. We'd been taking trust for granted. Contracts back up our deals and transactions, but who would sign them without trust in their counterparties? Trust is essential to building enduring connections with employees, suppliers, customers, and the communities in which we do business. And it drives the risk-taking that leads to innovation and progress.

But how do you gain it? It doesn't hurt to be honest and ethical. What most managers don't get, though, is that the best way to build trust is to extend it to others. I often think of a New York doughnut shop owner who decided, years back, to let customers make their own change from coins he left out on the counter. He was able to serve them faster, yes, but he also won loyal customers and left his competitors behind.



Netflix trusts its employees to take whatever vacation they feel they need. Rock band Radiohead released its last album online, trusting fans to decide how much to pay, and generated more revenue than all its previous releases. The University of Michigan Health System encourages doctors to apologize when they make mistakes, trusting patients to forgive them—and risking legal liability. The number of malpractice suits has dwindled, and other providers are adopting this approach.

My company, LRN, has long moved in this direction (and counseled our clients to do the same). One way that we've extended trust has to do with how colleagues spend company money. We want our people to file honest expense reports. Who doesn't? But instead of tightening oversight, we did away with it: no approvals required. We still do random report checks and track aggregate numbers. It helps us arrive at smarter policies on booking airfares, for example. There's a trust payoff, of course, but there's also less friction between managers and team members—and more time to do our jobs.

Recently our belief that extending trust is the best strategy was tested. We decided to restructure our business after taking a hard look at how effective we had been in our mission of inspiring principled performance in business. We saw that we needed more people who could expand our compliance and ethics education business and deliver new solutions suited to our larger mission. And we would have to let go of many from our 400-strong staff to hire those new people.

As counterintuitive as it may seem, we extended trust to the people losing their jobs, to those remaining, to customers, even to our competitors. We provided severance packages lasting up to six months; these days many companies are dialing back on this step, but we wanted to take responsibility for our decision. No one was asked to pack up and leave. Most stayed on for two weeks or more. When they left, we let them take their laptops and cell phones. And no one had to sign a form waiving the right to take us to court or compete with us or disparage us. Then we offered those staying a similar severance deal, in case they weren't fully on board. Two opted for it.

We took bold steps to keep our customers informed, sharing with them our internal memos, complete with financial and strategic details. We knew our rivals would get a look, but we trusted them not to mischaracterize the changes as weakness in our business.

LRN's outside legal counsel insisted on sitting down with me to talk me out of doing most of these things. I passed on that meeting. We'd be leaving ourselves vulnerable, our lawyers argued, but that's part of trusting others.

We recently surveyed employees—those going and staying—and found that 85% agreed with our decision and that 83% felt we handled the restructuring in the spirit of our values. We're a far more unified company now. We also have deeper ties to our customers, a number of whom have asked for help in building trust in their companies.

Managers have lots of tools for getting what they want out of their people, most of which fall into two categories: sticks and carrots. But to inspire employees to actually care, managers should judiciously put their own trust to use. | BW |

Dov Seidman is the founder, chairman, and CEO of LRN, a company that helps businesses develop ethical corporate cultures, and is the author of How: Why How We Do Anything Means Everything...in Business (and in Life).

Jack and Suzy Welch are off this week.

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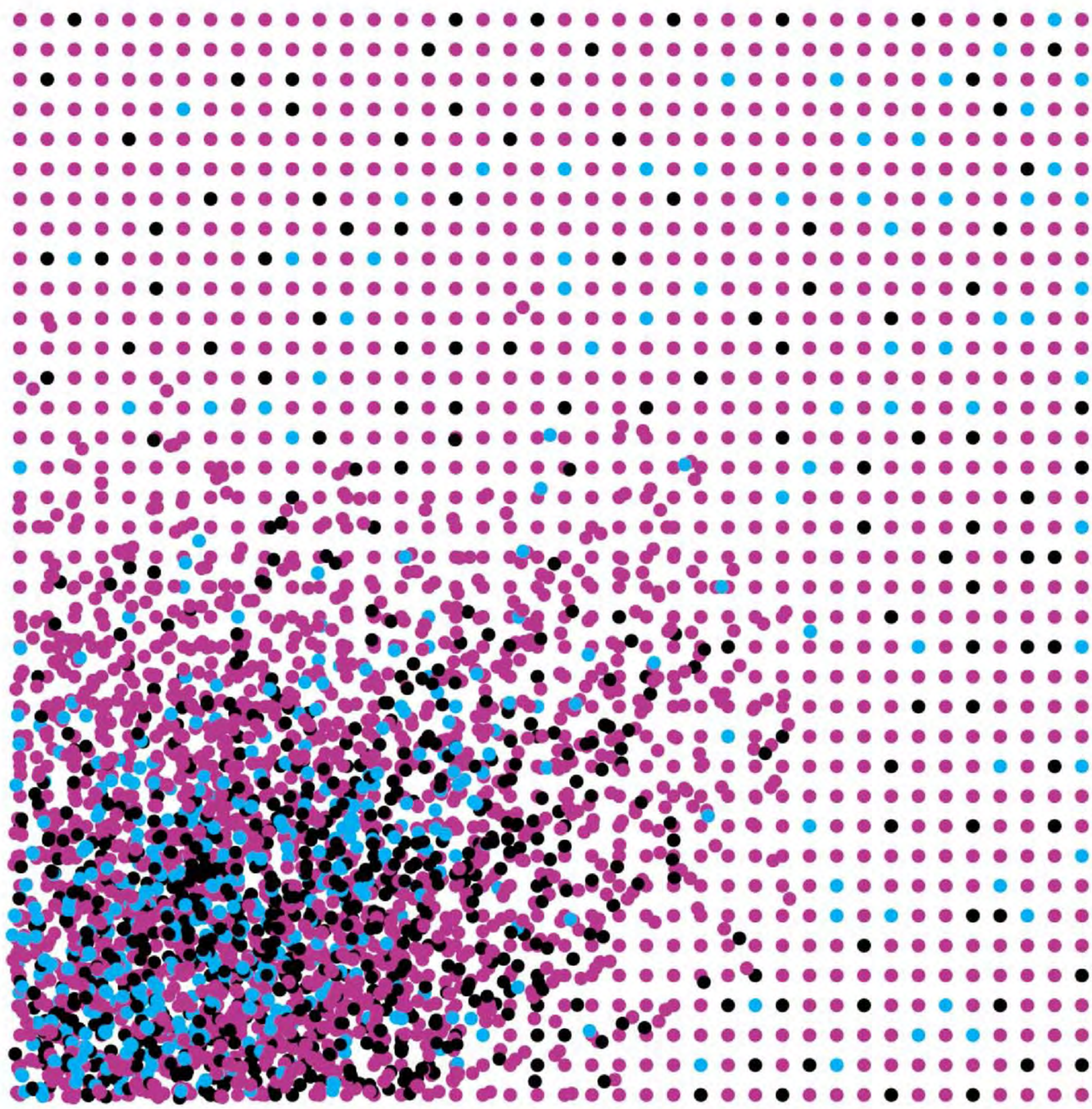
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